**NEW ISSUES**
**BOOK-ENTRY-ONLY**

**RATINGS: Moody's: A1**
**S&P: A+**
**Fitch: AA-**
**(See "RATINGS" herein)**

*In the opinion of the Attorney General of the State of California ("Attorney General") and Hawkins, Delafield & Wood ("Bond Counsel"), assuming compliance by the State and the Department with certain tax covenants described herein, the interest on the Offered Veterans G.O. Bonds is not included in gross income for federal income tax purposes under existing statutes and court decisions, and the interest on the Offered Veterans G.O. Bonds is exempt from personal income taxes of the State of California under present State law. The Attorney General and Bond Counsel are of the opinion that (i) the interest on the Series BM Bonds and Series BN Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Internal Revenue Code of 1986, as amended, with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for the purpose of calculating the alternative minimum tax imposed on such corporations, and (ii) interest on the Series BP Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Internal Revenue Code of 1986, as amended, with respect to individuals and corporations.*

# $171,665,000
# STATE OF CALIFORNIA
# VETERANS GENERAL OBLIGATION BONDS
## $66,600,000 Series BM (NON-AMT)
## $95,065,000 Series BN (NON-AMT)
## $10,000,000 Series BP (AMT)

**Dated: March 1, 1998**

**Due December 1,**
**As shown on the inside front cover page**

This offering consists of veterans general obligation bonds listed above (the "Offered Veterans G.O. Bonds") authorized by the voters of the State of California (the "State").

Interest is payable on June 1 and December 1 of each year, commencing June 1, 1998 for the Series BM Bonds and December 1, 1998 for the Series BN Bonds and Series BP Bonds. The Offered Veterans G.O. Bonds will be registered in the name of a nominee of The Depository Trust Company ("DTC"), which will act as securities depository for the Offered Veterans G.O. Bonds. Individual purchases of beneficial interests in the Offered Veterans G.O. Bonds may be made in book-entry form only, in the principal amount of $5,000 or any integral multiple thereof. See Appendix C—"BOOK-ENTRY SYSTEM."

**The Offered Veterans G.O. Bonds are subject to redemption prior to maturity, including redemption at par. See "THE OFFERED VETERANS G.O. BONDS—Redemption."**

**MATURITIES, PRINCIPAL AMOUNTS, INTEREST RATES AND PRICES OR YIELDS**
**[see inside front cover page]**

The Offered Veterans G.O. Bonds are general obligations of the State to which the full faith and credit of the State are pledged. Principal of, premium, if any, and interest on the Offered Veterans G.O. Bonds are payable from any moneys in the General Fund of the State, subject only to the prior application of such moneys to the support of the public school systems and public institutions of higher education. In addition, State law requires funds for the payment of debt service on the Offered Veterans G.O. Bonds to be transferred to the General Fund from the Veterans Farm and Home Building Fund of 1943. See "AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS—Security and Payment of Veterans G.O. Bonds."

The State Treasurer will apply to list the Series BM Bonds due December 1, 2025, the Series BN Bonds due December 1, 2021 and December 1, 2028, and the Series BP Bonds due December 1, 2026 on The New York Stock Exchange.

This cover page contains certain information for quick reference only. It is not a summary of this issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision.

*The Offered Veterans G.O. Bonds are offered when, as and if issued and received by the Underwriters, subject to the approval of legality by the Honorable Daniel E. Lungren, Attorney General, and by Hawkins, Delafield & Wood, Bond Counsel. Certain legal matters will be passed upon for the Underwriters by Kutak Rock, Underwriters' Counsel. Orrick, Herrington & Sutcliffe LLP has served as Special Counsel to the State Treasurer's Office in connection with the issuance of the Offered Veterans G.O. Bonds. O'Brien Partners Inc. has served as Financial Advisor in connection with the issuance of the Offered Veterans G.O. Bonds. The Series BM Bonds will be available for delivery on or about March 26, 1998, and the Series BN Bonds and Series BP Bonds will be available for delivery on or about May 5, 1998, as shown on the inside front cover page.*

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***Honorable Matt Fong***
***Treasurer of the State of California***

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**Bear, Stearns & Co. Inc.**

**BancAmerica Robertson Stephens** **E. J. De La Rosa & Co., Inc.** **Goldman, Sachs & Co.**
**Great Pacific Securities Inc.** **Lehman Brothers** **J.P. Morgan & Co.**
**PaineWebber Incorporated** **Samuel A. Ramirez & Co., Inc.**

Dated: March 11, 1998

## MATURITIES, PRINCIPAL AMOUNTS, INTEREST RATES AND PRICES OR YIELDS

**$66,600,000 Veterans Bonds Series BM (NON-AMT)—Price: 100%**

| Maturity Date (Dec. 1) | Principal Amount | Coupon | CUSIP Number | Maturity Date (Dec. 1) | Principal Amount | Coupon | CUSIP Number |
|---|---|---|---|---|---|---|---|
| 2002 | $ 100,000 | 4.10% | 130628XE5 | 2008 | $100,000 | 4.65% | 130628XL9 |
| 2003 | 6,520,000 | 4¼ | 130628XF2 | 2009 | 100,000 | 4¾ | 130628XM7 |
| 2004 | 6,595,000 | 4.35 | 130628XG0 | 2010 | 100,000 | 4.85 | 130628XN5 |
| 2005 | 100,000 | 4.40 | 130628XH8 | 2011 | 100,000 | 4.95 | 130628XP0 |
| 2006 | 100,000 | 4½ | 130628XJ4 | 2012 | 100,000 | 5.05 | 130628XQ8 |
| 2007 | 100,000 | 4.55 | 130628XK1 | 2013 | 100,000 | 5.10 | 130628XR6 |

**$52,485,000 5.45% Term Veterans Bonds due December 1, 2025 CUSIP No. 130628XS4**
(Plus accrued interest from dated date of March 1, 1998)
The Series BM Bonds will be delivered on or about March 26, 1998.

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**$95,065,000 Veterans Bonds Series BN (NON-AMT)**

| Maturity Date (Dec. 1) | Principal Amount | Coupon | Price or Yield | CUSIP Number | Maturity Date (Dec. 1) | Principal Amount | Coupon | Price or Yield | CUSIP Number |
|---|---|---|---|---|---|---|---|---|---|
| 2002 | $ 100,000 | 4.15% | 100% | 130628XT2 | 2008 | $100,000 | 4.70% | 100% | 130628XZ8 |
| 2003 | 11,000,000 | 4.30 | 100 | 130628XU9 | 2009 | 100,000 | 4.80 | 100 | 130628YA2 |
| 2004 | 8,810,000 | 4.40 | 100 | 130628XV7 | 2010 | 100,000 | 4.90 | 100 | 130628YB0 |
| 2005 | 3,910,000 | 4.45 | 100 | 130628XW5 | 2011 | 100,000 | 5.00 | 100 | 130628YC8 |
| 2006 | 100,000 | 4.55 | 100 | 130628XX3 | 2012 | 100,000 | 5.10 | 100 | 130628YD6 |
| 2007 | 100,000 | 4.60 | 100 | 130628XY1 | 2013 | 100,000 | 5.15 | 100 | 130628YE4 |

**$24,870,000 5⅜% Term Veterans Bonds due December 1, 2021—Priced to Yield: 5.42% CUSIP No. 130628YF1**
**$45,575,000 5.45% Term Veterans Bonds due December 1, 2028—Price: 100% CUSIP No. 130628YG9**
(Plus accrued interest from dated date of March 1, 1998)
The Series BN Bonds will be delivered on or about May 5, 1998.

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**$10,000,000 Veterans Bonds Series BP (AMT)—Price: 100%**

| Maturity Date (Dec. 1) | Principal Amount | Coupon | CUSIP Number | Maturity Date (Dec. 1) | Principal Amount | Coupon | CUSIP Number |
|---|---|---|---|---|---|---|---|
| 2002 | $100,000 | 4¼% | 130628YH7 | 2008 | $255,000 | 4.90% | 130628YP9 |
| 2003 | 100,000 | 4.40 | 130628YJ3 | 2009 | 275,000 | 5.00 | 130628YQ7 |
| 2004 | 100,000 | 4½ | 130628YK0 | 2010 | 295,000 | 5.10 | 130628YR5 |
| 2005 | 100,000 | 4.60 | 130628YL8 | 2011 | 315,000 | 5.20 | 130628YS3 |
| 2006 | 245,000 | 4.70 | 130628YM6 | 2012 | 335,000 | 5¼ | 130628YT1 |
| 2007 | 240,000 | 4.80 | 130628YN4 | 2013 | 355,000 | 5.30 | 130628YU8 |

**$7,285,000 5½% Term Veterans Bonds due December 1, 2026 CUSIP No. 130628YV6**
(Plus accrued interest from dated date of March 1, 1998)
The Series BP Bonds will be delivered on or about May 5, 1998.

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**No dealer, broker, salesperson or other person has been authorized by the State to give any information or to make any representations other than those contained herein and, if given or made, such other information or representations must not be relied upon as having been authorized by the State.**

**This Official Statement is not to be construed as a contract with the purchasers of the Offered Veterans G.O. Bonds. Statements contained in this Official Statement which involve estimates, forecasts or matters of opinion, whether or not expressly so described herein, are intended solely as such and are not to be construed as representations of facts.**

**The information set forth herein has been obtained from official sources which are believed to be reliable, but it is not guaranteed as to accuracy or completeness. The information and expressions of opinion herein are subject to change without notice, and neither delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the State since the date hereof.**

**IN CONNECTION WITH THIS OFFERING THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE OFFERED VETERANS G.O. BONDS OFFERED HEREBY AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.**

**This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of the Offered Veterans G.O. Bonds, by any person in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation or sale.**

Copies of this Official Statement may be obtained from:


**HONORABLE MATT FONG**
Treasurer of the State of California
P.O. Box 942809
Sacramento, California 94209-0001
(916) 653-3451

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# OFFICIAL STATEMENT

# $171,665,000

# STATE OF CALIFORNIA
# VETERANS GENERAL OBLIGATION BONDS

## $66,600,000 Series BM (NON-AMT)
## $95,065,000 Series BN (NON-AMT)
## $10,000,000 Series BP (AMT)

## INTRODUCTION

*This introduction is a brief summary of the terms of the State of California Veterans General Obligation Bonds listed above (the "Offered Veterans G.O. Bonds") and a brief description of the Official Statement; a full review should be made of the entire Official Statement. All statements contained in this introduction are qualified in their entirety by reference to the entire Official Statement. Summaries of provisions of the Constitution and other laws of the State of California or of any other documents referred to in this Official Statement do not purport to be complete and such summaries are qualified in their entirety by references to the complete provisions.*

### Description of the Offered Veterans G.O. Bonds

The issuance of veterans general obligation bonds ("Veterans G.O. Bonds") is authorized by Bond Acts (defined below) approved by the voters of the State of California (the "State") and by resolutions of the Veterans Finance Committee of 1943. The Offered Veterans G.O. Bonds are authorized by specific Bond Acts and are being issued to finance or refinance obligations issued to finance the purchase of homes and farms for California military veterans under the Farm and Home Purchase Program (the "Program") of the State Department of Veterans Affairs (the "Department") or to refund certain outstanding Veterans G.O. Bonds. The Offered Veterans G.O. Bonds are being issued in eight separate series which are being offered in three groups, each group of which is referred to in this Official Statement by its two-letter designation. See "THE OFFERED VETERANS G.O. BONDS—Identification and Authorization of the Offered Veterans G.O. Bonds."

The Offered Veterans G.O. Bonds will be registered in the name of a nominee of The Depository Trust Company ("DTC") which will act as securities depository for the Offered Veterans G.O. Bonds. Purchases of beneficial interests in the Offered Veterans G.O. Bonds may be in book-entry form only, in the principal amount of $5,000 or any integral multiple thereof. Principal and interest are payable as specified on the cover page and inside front cover page of this Official Statement.

### Security and Sources of Payment for the Veterans G.O. Bonds

The Veterans G.O. Bonds are general obligations of the State to which the full faith and credit of the State are pledged (see "AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS—Security and Payment of Veterans G.O. Bonds" below). Principal of and interest on the Veterans G.O. Bonds are payable from moneys in the General Fund of the State Treasury (the "General Fund") (see Appendix A—"THE STATE OF CALIFORNIA—State Finances—The General Fund"), subject only to the prior application of moneys in the General Fund to the support of the public school system and public institutions of higher education. The Bond Acts authorizing the Veterans G.O. Bonds provide that the State shall collect annually, in the same manner and at the same time as it collects other State revenues, a sum sufficient, in addition to the ordinary revenues of the State, to pay the principal of and interest on the Veterans G.O. Bonds. In addition, State law requires funds for the payment of debt service on the Veterans G.O. Bonds to be transferred to the General Fund from the Veterans Farm and Home Building Fund of 1943 (the "1943 Fund"). See "AUTHORIZATION OF AND SECURITY FOR THE VETERANS G.O. BONDS—Security and Payment of Veterans G.O. Bonds" and Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND."

**Redemption**

Offered Veterans G.O. Bonds are subject to optional redemption prior to their respective stated maturity dates. All Offered Veterans G.O. Bonds are also subject to special redemption at par prior to maturity. The Series BM Bonds maturing on December 1, 2025, Series BN Bonds maturing on December 1, 2021 and December 1, 2028, and Series BP Bonds maturing on December 1, 2026, respectively, are subject to mandatory redemption at par prior to their stated maturities, in part, from sinking fund payments made by the State. See "THE OFFERED VETERANS G.O. BONDS—Redemption."

**Tax Matters**

In the opinion of the Attorney General of the State of California ("Attorney General") and Hawkins, Delafield & Wood ("Bond Counsel"), assuming compliance by the State and the Department with certain tax covenants described herein, the interest on the Offered Veterans G.O. Bonds is not included in gross income for federal income tax purposes under existing statutes and court decisions, and the interest on the Offered Veterans G.O. Bonds is exempt from personal income taxes of the State of California under present State law. The Attorney General and Bond Counsel are of the opinion that (i) the interest on the Series BM Bonds and Series BN Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Internal Revenue Code of 1986, as amended, with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for the purpose of calculating the alternative minimum tax imposed on such corporations, and (ii) interest on the Series BP Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Internal Revenue Code of 1986, as amended, with respect to individuals and corporations. See "TAX MATTERS" below and Appendix E—"PROPOSED FORMS OF LEGAL OPINIONS."

**Certain Information Related to this Official Statement**

The information and expressions of opinion herein speak only as of their date and are subject to change without notice. Neither delivery of this Official Statement nor any sale made hereunder, shall, under any circumstances, create any implication that there has been no change in the affairs of the State since the date hereof.

All financial and other information presented in this Official Statement has been provided by the State from its records, except for information expressly attributed to other sources. The presentation of information, including tables of receipts from taxes and other revenues, is intended to show recent historic information and is not intended to indicate future or continuing trends in the financial position or other affairs of the State. No representation is made that past experience, as it might be shown by such financial and other information, will necessarily continue or be repeated in the future.

**Continuing Disclosure**

The State Treasurer will agree on behalf of the State to provide annually certain financial information and operating data relating to the State by not later than April 1 of each year in which any Offered Veterans G.O. Bonds are outstanding (the "Treasurer's Annual Report"), commencing with the report for the 1997-98 Fiscal Year, and to provide notices of the occurrence of certain other enumerated events if material. The Secretary of the Department will agree to provide certain financial information and operating data relating to the Program by no later than April 1 of each year in which any Offered Veterans G.O. Bonds are outstanding (the "Department's Annual Report"), commencing with the report for the 1997-1998 Fiscal Year. The specific nature of the information to be contained in the Treasurer's Annual Report and the Department's Annual Report or the notices of material events and certain other terms of the continuing disclosure obligations are summarized below under Appendix D—"SUMMARY OF CONTINUING DISCLOSURE CERTIFICATES."

**Additional Information**

Questions regarding this Official Statement and the issuance of these securities may be addressed to the office of the Honorable Matt Fong, Treasurer of the State of California, P.O. Box 942809, Sacramento, CA 94209-0001, telephone (916) 653-3451. Questions regarding the Program should be addressed to the Bond Finance Division of the Department of Veterans Affairs, P.O. Box 942895, Sacramento, CA 94295-0001, telephone (916) 653-2081.

## AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS

**Authorization**

Each general obligation bond act authorizing the issuance of Veterans G.O. Bonds (each, a "Bond Act") incorporates by reference the State General Obligation Bond Law (the "Law"), which is set forth in Chapter 4 (commencing with Section 16720) of Part 3 of Division 4 of Title 2 of the California Government Code. The Law provides a procedure for the authorization, sale, issuance, use of proceeds, repayment and refunding of State general obligation bonds.

**Security and Payment of Veterans G.O. Bonds**

The Veterans G.O. Bonds are general obligations of the State, payable in accordance with the Bond Acts out of the General Fund. The full faith and credit of the State are pledged for the punctual payment of principal of and interest on the Veterans G.O. Bonds. The Bond Acts provide that the State shall collect annually in the same manner and at the same time as it collects other State revenue an amount sufficient, in addition to the ordinary revenue of the State, to pay principal of and interest on the Veterans G.O. Bonds. Each Bond Act also contains a continuing appropriation from the General Fund of the sum annually necessary to pay principal of and interest on the Veterans G.O. Bonds. Payment of principal of, premium, if any, and interest on the Veterans G.O. Bonds from the General Fund is subject only to the prior application of moneys in the General Fund to the support of the public school system and public institutions of higher education.

The Department's principal fund is the 1943 Fund described in Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The 1943 Fund." The Military and Veterans Code of the State (the "Veterans Code"), of which the Bond Acts are a part, requires that on the dates when funds are to be remitted to Bondowners for the payment of debt service on Veterans G.O. Bonds in each fiscal year, there shall be transferred to the General Fund to pay the debt service on Veterans G.O. Bonds all of the money in the 1943 Fund (but not in excess of the amount of debt service then due and payable). If the money so transferred on the remittance dates is less than the debt service then due and payable, the balance remaining unpaid is required by the Veterans Code to be transferred to the General Fund out of the 1943 Fund as soon as it shall become available, together with interest thereon from the remittance date until paid, at the same rate of interest as borne by the Veterans G.O. Bonds, compounded semiannually.

The Veterans Code does not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds. Outstanding home purchase revenue bonds in the aggregate principal amount of $120,990,000 previously issued by the Department, plus $154,065,000 previously sold by the Department and scheduled to be issued on May 5, 1998, and any additional home purchase revenue bonds issued by the Department in the future (collectively, the "Revenue Bonds") are and will be special obligations of the Department payable solely from, and secured by a pledge of, an undivided interest in the assets of the 1943 Fund (other than proceeds of Veterans G.O. Bonds or any amounts in any rebate account) and any reserve accounts established for the benefit of Revenue Bonds. The Veterans Code provides that this undivided interest in the 1943 Fund is secondary and subordinate to any interest or right in the assets of the 1943 Fund of the people of the State and of the holders of the Veterans G.O. Bonds (that is, the right to payment or reimbursement of debt service on Veterans G.O. Bonds described in the preceding paragraph). If debt service payments to the General Fund are current and all reimbursement of debt service payments with interest as described in the preceding paragraph have been made, no holder or beneficial owner of Veterans G.O. Bonds has any right to restrict disbursements by the Department from the 1943 Fund for any lawful purpose, including payment of debt service on or redemptions and purchases of Revenue Bonds.

The Program has experienced significant losses during the last five fiscal years, which have caused decreases in the retained earnings in the 1943 Fund. For additional information, see Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The 1943 Fund" and Exhibit 1 to Appendix B—"Department Audited Financial Statements."

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## PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES

Under the Program, the Department acquires residential property to be sold to eligible veterans under contracts of purchase between the Department and such veterans ("Contracts of Purchase"). Such acquisition is financed principally with the proceeds of Veterans G.O. Bonds and Revenue Bonds. The issuance of the Offered Veterans G.O. Bonds is for the purpose of restructuring the Department's outstanding debt and further implementing the Program. The plan of finance is outlined below.

### Plan of Finance

The Department has developed the financing plan described under this subheading to lower the cost of the outstanding indebtedness which financed the existing Contracts of Purchase and the funds currently available to finance new Contracts of Purchase, and to make additional funds available to finance new Contracts of Purchase. The Department expects to apply substantially all of its debt service cost savings to reduce the interest rate on existing Contracts of Purchase. The Department initiated this financing plan through the issuance in December 1997 and January 1998 of $1,166,970,000 principal amount of Veterans G.O. Bonds and $120,990,000 principal amount of Revenue Bonds. As part of the overall plan of finance, $154,065,000 of Revenue Bonds have been sold and are expected to be issued on or about May 5, 1998. The issuance of the Offered Veterans G.O. Bonds is an additional phase of this financing plan. The application of proceeds of the Offered Veterans G.O. Bonds and of certain other available moneys is expected to result in the retirement (including payment at maturity) of certain Veterans G.O. Bonds and certain Revenue Bonds as follows:

| Veterans General Obligation Bonds | | Revenue Bonds |
|---|---|---|
| $ 10,800,000 Series TT | $ 1,100,000 Series AB | $ 5,665,000 1991 Series A |
| $ 19,200,000 Series UU | $ 5,500,000 Series AC | |
| $ 18,000,000 Series VV | $ 6,600,000 Series AD | |
| $ 42,600,000 Series WW | $ 3,520,000 Series AE | |
| $ 28,400,000 Series XX | $ 5,280,000 Series AF | |
| $ 6,600,000 Series YY | $ 4,000,000 Series AH | |
| $ 4,400,000 Series ZZ | $ 10,000,000 Series BF | |

See Exhibit 2 to Appendix B "Certain Department Financial Information and Operating Data."

The issuance of the Offered Veterans G.O. Bonds, and certain federal tax-related reallocations, are expected to result in moneys becoming available for new Contracts of Purchase. Certain of such moneys relate to certain of the Series BN Bonds and Series BP Bonds and will become available when such bonds are issued. See Exhibit 2 to Appendix B—"Certain Department Financial Information and Operating Data—Contracts of Purchase—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments." In addition, the Contracts of Purchase financed by the retired bonds will be reallocated to the Offered Veterans G.O. Bonds.

The Department's goal in issuing the Offered Veterans G.O. Bonds is to make moneys available to finance Contracts of Purchase for veterans who, for federal tax purposes, are not eligible for financing from certain other Department funding sources. The Department further expects to use prepayments of such Contracts of Purchase to continue to assist such veterans in the future ("recycling"). Although this is the Department's current expectation, such expectation is subject to change and such moneys or prepayments may be applied to redeem Offered Veterans G.O. Bonds, other Veterans G.O. Bonds, and Revenue Bonds. See "THE OFFERED VETERANS G.O. BONDS—Redemption—Special Redemption from Unused Proceeds and Excess Revenues."

**Department's Programmatic Changes**

The Department has completed or has in progress a number of significant changes to the Program. The Department's principal goal has been to enhance the benefits provided to veterans with Contracts of Purchase by lowering the interest rate on existing Contracts of Purchase, providing an interest rate on new Contracts of Purchase which more closely reflects its borrowing costs, better servicing Contracts of Purchase to reduce real estate losses, obtaining mortgage insurance to reduce exposure to future real estate losses, and revamping the various insurance products the Department offers to veterans with Contracts of Purchase.

The Veterans Code currently requires that all Contracts of Purchase bear a uniform interest rate which is subject to periodic adjustment. (There are statutory exceptions to the uniform rate requirement, but the impact of these exceptions on the Program is *de minimis.*) The Department has submitted legislative changes to eliminate the uniform rate and periodic adjustment requirements and to permit down payments lower than 5%. This will allow the Department to offer fixed interest rates on future Contracts of Purchase which more closely reflect its costs of borrowing. Until such legislative changes are made, new Contracts of Purchase will be originated under the current statutory provisions. There can be no assurance that the Department will be able to obtain the legislative changes it seeks.

The current uniform interest rate on approximately 98% of the existing Contracts of Purchase is 8.0% per annum. Effective April 1, 1998, this rate will be reduced to 6.95% as a consequence of those portions of the plan of finance effectuated in December 1997. Legislation effective January 1, 1998 has expanded veteran eligibility under State law for certain funding sources to include Peacetime Veterans (defined under Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program—Qualifying Veteran Status—Veterans Code"). The Department expects that this eligibility expansion, coupled with expected lowered interest rates on Contracts of Purchase, will increase Program demand.

The Department has undertaken a series of steps designed to address real estate losses and loss exposure. It has centralized and reorganized its loan servicing and begun updating its automated loan accounting and servicing functions. It has set aside additional reserves for loan losses. It is in the process of obtaining primary mortgage insurance (with a deductible) for a portion of the existing Contracts of Purchase with high loan-to-value ratios, and is working on procedures for loan guarantees from the United States Department of Veterans Affairs ("USDVA") for most new Contracts of Purchase with high loan-to-value ratios.

The Veterans Code and/or long-standing Department policies have called for the Department to provide casualty and life and disability insurance for veterans with Contracts of Purchase. During the period that the Department self-insured this liability, the Department experienced significant losses. Over the past few years it has undertaken significant steps to reduce its losses, including obtaining outside providers for some portions of these various types of insurance.

Additional information regarding the Department's programmatic changes is set forth under Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program." For additional discussion of qualifying veterans and interest rates on Contracts of Purchase, see, respectively, Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program—Qualifying Veteran Status" and "—Contracts of Purchase." For additional discussion of real estate losses, see Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program—Loan Insurance" and "—Selected Financial

Data of the 1943 Fund and Department's Discussion." For additional discussion of the Department's insurance programs, see Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program—Property and Life and Disability Insurance."

## THE OFFERED VETERANS G.O. BONDS

The Offered Veterans G.O. Bonds will be registered in the name of a nominee of The Depository Trust Company ("DTC"), which will act as securities depository for the Offered Veterans G.O. Bonds. Purchases of beneficial interests in the Offered Veterans G.O. Bonds may be made in book-entry form only, in the principal amount of $5,000 or any integral multiple thereof. See Appendix C—"BOOK-ENTRY SYSTEM."

The Offered Veterans G.O. Bonds will be dated the applicable date, and will mature on the dates and in the amounts, set forth on the inside front cover page hereof. Interest is payable on June 1 and December 1 in each year (each, an "Interest Payment Date"), commencing June 1, 1998 for the Series BM Bonds and December 1, 1998 for the Series BN Bonds and Series BP Bonds, at the respective rates shown on the inside cover page of this Official Statement. Interest on the Offered Veterans G.O. Bonds shall be calculated on the basis of a 360-day year comprised of twelve thirty-day months.

Principal and interest are payable directly to DTC by the State Treasurer. Upon receipt of payments of principal and interest, DTC is to in turn remit such principal and interest to the participants in DTC for disbursement to the beneficial owners of the Offered Veterans G.O. Bonds. The record date for the payment of interest on the Offered Veterans G.O. Bonds is the close of business on the 15th day of the month immediately preceding an Interest Payment Date, whether or not the day is a business day.

### Identification and Authorization of the Offered Veterans G.O. Bonds

The Offered Veterans G.O. Bonds are issued under five Bonds Acts, each authorized by the voters. See Appendix A—"THE STATE OF CALIFORNIA—State Indebtedness." The Offered Veterans G.O. Bonds are being issued for the purpose of refunding certain outstanding Veterans G.O. Bonds and Revenue Bonds, which have been issued and are outstanding, and which financed the Program. The Veterans G.O. Bonds and Revenue Bonds being retired will all be repaid within ninety days after the delivery of the Offered Veterans G.O. Bonds, so as to constitute a "current refunding" for federal tax purposes. See "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES—Plan of Finance."

1. $6,600,000 Principal amount of Veterans Bonds, Series BM1, authorized under the Veterans Bond Act of 1976 (NON-AMT);

2. $6,600,000 Principal amount of Veterans Bonds, Series BM2, authorized under the Veterans Bond Act of 1978 (NON-AMT);

3. $53,400,000 Principal amount of Veterans Bonds, Series BM3, authorized under the Veterans Bond Act of 1996 (NON-AMT);

4. $4,000,000 Principal amount of Veterans Bonds, Series BN1, authorized under the Veterans Bond Act of 1980 (NON-AMT);

5. $4,400,000 Principal amount of Veterans Bonds, Series BN2, authorized under the Veterans Bond Act of 1976 (NON-AMT);

6. $15,400,000 Principal amount of Veterans Bonds, Series BN3, authorized under the Veterans Bond Act of 1978 (NON-AMT);

7. $71,265,000 Principal amount of Veterans Bonds, Series BN4, authorized under the Veterans Bond Act of 1996 (NON-AMT);

8. $10,000,000 Principal amount of Veterans Bonds, Series BP, authorized under the Veterans Bond Act of 1990 (AMT);

**Redemption**

*Sinking Fund Redemption*

Series BM Bonds maturing on December 1, 2025, Series BN Bonds maturing on December 1, 2021 and December 1, 2028, and Series BP Bonds maturing on December 1, 2026, respectively, are subject to redemption prior to their respective stated maturity dates, in part, by lot, from sinking fund payments, at a redemption price of 100 percent of the principal amount thereof, plus accrued interest to the date fixed for redemption, without premium, on the respective dates and in the respective amounts shown below.

**SINKING FUND REDEMPTION SCHEDULE**

| Date (December 1) | Series BM Bonds Maturing December 1, 2025 | Series BN Bonds Maturing December 1, 2021 | Series BN Bonds Maturing December 1, 2028 | Series BP Bonds Maturing December 1, 2026 |
|---|---|---|---|---|
| 2014 | $ 100,000 | $ 100,000 | | $380,000 |
| 2015 | 100,000 | 100,000 | | 405,000 |
| 2016 | 100,000 | 100,000 | | 430,000 |
| 2017 | 100,000 | 100,000 | | 455,000 |
| 2018 | 100,000 | 100,000 | | 485,000 |
| 2019 | 6,105,000 | 7,565,000 | | 515,000 |
| 2020 | 6,605,000 | 8,165,000 | | 545,000 |
| 2021 | 6,990,000 | 8,640,000† | | 580,000 |
| 2022 | 7,400,000 | | $ 9,145,000 | 615,000 |
| 2023 | 7,830,000 | | 9,680,000 | 655,000 |
| 2024 | 8,285,000 | | 10,245,000 | 695,000 |
| 2025 | 8,770,000† | | 10,840,000 | 740,000 |
| 2026 | | | 100,000 | 785,000† |
| 2027 | | | 100,000 | |
| 2028 | | | 5,465,000† | |

† Stated Maturity

If less than all of the Term Bonds of a maturity of a Series of the Offered Veterans G.O. Bonds are purchased or called for redemption (other than in satisfaction of sinking fund payments), the State Treasurer will credit the principal amount of such Term Bonds that are so purchased or redeemed against applicable remaining sinking fund payments (including the principal amounts due on the respective maturity dates, as shown above), as requested by the Department.

*Optional Redemption*

The Series BM Bonds and Series BN Bonds maturing on and before December 1, 2004 are subject to optional redemption prior to their respective stated maturity dates, at the option of the State upon request of the Department, in whole or in part (of any Series, of any maturities within a Series, and by lot within each maturity of each Series), on any date on or after June 1, 2000, at a redemption price of 100 percent of the principal amount† hereof, plus accrued interest to the date fixed for redemption.

The Offered Veterans G.O. Bonds maturing on and after December 1, 2004 (except the Series BM Bonds and Series BN Bonds maturing on December 1, 2004) are subject to optional redemption prior to their respective stated maturity dates, at the option of the State upon request of the Department, in whole or in part (of any Series, of any maturity within a Series, and by lot within each maturity of each Series), on any date on or after December 1, 2003 at the redemption prices stated below, plus accrued interest to the date fixed for redemption:

| Redemption Dates (both dates inclusive) | Redemption Price (as percentage of principal amount redeemed) |
|---|---|
| December 1, 2003 to November 30, 2004 | 101% |
| December 1, 2004 and thereafter | 100 |

*Special Redemption from Unexpended Proceeds and Excess Revenues*

The Offered Veterans G.O. Bonds are also subject to special redemption prior to their respective stated maturity dates, at the option of the State upon request of the Department, from (i) moneys deposited on or prior to August 1, 1998 in the related Series Proceeds Subaccount for the Offered Veterans G.O. Bonds that have not been applied to redeem Veterans G.O. Bonds or to finance Contracts of Purchase and (ii) Excess Revenues (as defined below) derived from any Veterans G.O. Bonds and any Revenue Bonds. Any such redemption may be on any date, in whole or in part (of any Series and of any maturities within a Series at the option of the State upon request of the Department, and by lot within such maturity of such Series), at the principal amount thereof plus accrued interest to the date fixed for redemption, without premium.

Moneys are currently available through the issuance of Veterans G.O. Bonds and Revenue Bonds to finance Contracts of Purchase, and additional moneys may become available to finance Contracts of Purchase through the future issuances of Revenue Bonds and Veterans G.O. Bonds. Since the Department has full discretion, subject to eligibility requirements and the requirements of the Internal Revenue Code of 1954, as amended, and the Internal Revenue Code of 1986, as amended (collectively, the "Federal Tax Code"), in applying the proceeds of all of these bonds to finance the Program, the proceeds of prior and future bonds may be used to finance Contracts of Purchase before proceeds of the Offered Veterans G.O. Bonds.

Although the Department's goal is to use moneys made available through the issuance of the Offered Veterans G.O. Bonds (including recycled prepayments) to finance Contracts of Purchase for veterans who do not qualify under the Federal Tax Code for other sources of Department funding, such expectation is subject to change, and such moneys or prepayments would then be available to redeem Offered Veterans G.O. Bonds, other Veterans G.O. Bonds, and Revenue Bonds. See "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES—Plan of Finance."

Excess Revenues can include prepayments and repayments on Contracts of Purchase funded by Revenue Bonds and Veterans G.O. Bonds, and also includes Revenues which had been set aside to be recycled into new Contracts of Purchase. All payments on Contracts of Purchase are deposited in the 1943 Fund and applied to pay or reimburse debt service on the Veterans G.O. Bonds, to pay debt service on Revenue Bonds, to pay for mandatory redemptions of Veterans G.O. Bonds and Revenue Bonds, to pay Program and Department expenses, and to pay certain insurance claims. The Department, subject to applicable bond authorizing resolutions, may apply Excess Revenues to redeem any Veterans G.O. Bonds or Revenue Bonds eligible for redemption. The Department's decision to apply Excess Revenues to redeem bonds, to finance new Contracts of Purchase, or for any other permitted purpose depends on many factors, including applicable bond authorizing resolution requirements, demand for Contracts of Purchase, debt service cost savings, investment earnings, and Federal Tax Code requirements.

Certain of the outstanding Veterans G.O. Bonds are not subject to redemption prior to maturity. See Exhibit 2 to Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—Certain Department Financial Information and Operating Data—Veterans G.O. Bonds and Revenue Bonds."

"Excess Revenues" means all Revenues, including prepayments and repayments on Contracts of Purchase which represent at any time an excess over Accrued Debt Service. See Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The 1943 Fund—Excess Revenues."

*Notice of Redemption*

When redemption is required while the Offered Veterans G.O. Bonds are in book-entry only form, the State Treasurer shall give notice of redemption by mailing copies of such notice only to DTC (not to the owners of the Offered Veterans G.O. Bonds) not less than thirty or more than sixty days prior to the date fixed for redemption. DTC, in turn, is to send the notice of redemption to its participants for distribution to the beneficial owners of the Offered Veterans G.O. Bonds. See Appendix C—"BOOK-ENTRY SYSTEM." The notice will state, among other things, that the Offered Veterans G.O. Bonds or a designated portion thereof (in the case of redemption of a Offered Veterans G.O. Bond in part but not in whole) are to be redeemed, the dated date of the Offered Veterans G.O. Bonds, the redemption date, the Series and maturities of the Offered Veterans G.O. Bonds to be redeemed and the redemption price. The notice will also state that after the date fixed for redemption, no further interest will accrue on the principal of any Offered Veterans G.O. Bonds called for redemption. Notice of redemption will also be provided by mail to certain financial services and securities depository services.

### New York Stock Exchange Listing

The State Treasurer expects to list the Series BM Bonds due December 1, 2025, the Series BN Bonds due December 1, 2021 and December 1, 2028, and the Series BP Bonds due December 1, 2026 on The New York Stock Exchange. There can be no assurance that such Term Bonds will be listed or will continue to be listed for the duration of the time they will be outstanding.

## TAX MATTERS

### Federal Tax Matters

The Series BM Bonds, Series BN Bonds and Series BP Bonds are being issued as a single issue for certain federal tax law purposes. The requirements of applicable federal tax law must be satisfied with respect to the Offered Veterans G.O. Bonds in order that interest on the Offered Veterans G.O. Bonds not be included in gross income for federal income tax purposes retroactive to the date of issuance thereof.

*Loan Eligibility Requirements Imposed by the Federal Tax Code*

The Federal Tax Code contains the following loan eligibility requirements, which are applicable to new Contracts of Purchase (or portions of new Contracts of Purchase) entered into with respect to properties acquired with amounts allocable to qualified veterans' mortgage bonds (the "QVMB Contracts") but which are not applicable to the Contracts of Purchase entered into with respect to properties acquired with amounts allocable to bonds issued prior to, or subject to a transition rule related to, the Mortgage Subsidy Bond Tax Act of 1980 (such Contracts of Purchase, the "pre-Ullman Contracts"). A portion of the Offered Veterans G.O. Bonds are qualified veterans' mortgage bonds and the remainder are pre-Ullman bonds. These requirements must be satisfied for QVMB Contracts as applicable, in order that interest on the Offered Veterans G.O. Bonds not be included in gross income for federal income tax purposes retroactive to their date of issuance.

*Residence Requirement.* The Federal Tax Code requires that each of the premises financed with proceeds of qualified veterans' mortgage bonds be a one-to-four family residence, one unit of which can reasonably be expected to become the principal residence of the veteran within a reasonable time after the financing is provided. Certain documents adopted by the Department establish procedures to be followed in connection with QVMB Contracts which finance the acquisition of single family homes in order to assure that interest paid on the Offered Veterans G.O. Bonds not be included in gross income for federal income tax purposes under the Federal Tax Code (the "Veterans Program Documents"). Certain documents adopted by the Department establish procedures to be followed in connection with QVMB Contracts to finance home improvement loans in order to assure that interest paid on the Offered Veterans G.O. Bonds is not included in gross income for federal income tax purposes under the Federal Tax Code (the "Home Improvement Program Documents"; together with the Veterans Program Documents, the "Program Documents"). In connection with the financing of a QVMB Contract, the Program Documents require that each veteran submit an affidavit stating such person's intention to occupy the premises as his principal residence within 60 days after closing of the QVMB Contract.

*Qualified Veteran Requirement.* The Federal Tax Code requires that each mortgagor to whom financing is provided under a qualified veterans' mortgage bond issue have served on active duty at some time before January 1, 1977 and apply or applied for financing before the later of January 31, 1985 or the date which is 30 years after the last date on which the veteran left active service. The Department has established procedures and has covenanted to comply with such requirement.

*New Mortgage Requirement.* The Federal Tax Code requires that, with certain limited exceptions, the lendable proceeds of qualified veterans' mortgage bonds finance new mortgage loans only and that no proceeds may be used to acquire or replace an existing mortgage loan, which would include the refinancing of a pre-existing mortgage loan. The Program Documents provide that the Department will verify compliance with the new mortgage requirement by requiring each veteran to certify prior to financing, subject to such exceptions, that no refinancing of a prior mortgage loan is being effected.

*Qualified Home Improvement Loans.* The Federal Tax Code requires that a home improvement loan financed with the lendable proceeds of qualified veterans mortgage bonds be made only with respect to an owner-occupied residence, and finance alterations, repairs, and improvements on or in connection with an existing one-to-four-family residence by the owner thereof, but only if such alterations, repairs and improvements substantially protect or improve the basic livability or energy efficiency of the property. The Program Documents require that the Department establish procedures to comply with such requirement.

*General.* An issue of qualified veterans' mortgage bonds is treated as meeting the loan eligibility requirements of the Federal Tax Code if (i) the issuer in good faith attempted to meet all the loan eligibility requirements before the mortgage loans were executed, (ii) any failure to comply with the loan eligibility requirements is corrected within a reasonable period after such failure is first discovered, and (iii) 95% or more of the proceeds of the issue used to make mortgage loans was used to finance residences that met all such requirements at the time the mortgage loans were executed. In determining whether 95% or more of the proceeds has been so used, the Federal Tax Code permits the Department to rely on an affidavit of the veteran even if the relevant information in such affidavit ultimately proved to be untrue, unless the Department knows or has reason to believe that such information is false.

*Other Requirements Imposed by the Federal Tax Code*

*General.* Failure to comply with the applicable provisions of the Federal Tax Code may result in interest on the applicable issue of bonds being included in gross income for federal income tax purposes retroactive to the date of issuance thereof. The Federal Tax Code provides that gross income for federal income tax purposes does not include interest on a mortgage revenue bond if it is a qualified veterans' mortgage bond or if it meets the transition rules applicable to pre-Ullman bonds. A qualified veterans' mortgage bond is part of an issue 95 percent or more of the net proceeds of which are used to provide residences to veterans and that meets certain (i) general requirements, (ii) arbitrage restrictions on the use and investments of proceeds of the issue, and (iii) loan eligibility requirements set forth in the Federal Tax Code and as more fully described above under "Loan Eligibility Requirements Imposed by the Federal Tax Code." A pre-Ullman bond issue must meet (i) and (ii) as further described below.

The first general requirement of the Federal Tax Code which is applicable to the Offered Veterans G.O. Bonds (including the pre-Ullman portion of such Bonds) is that the aggregate amount of qualified veterans' mortgage bonds not exceed the volume limit based on statutory formula. The Offered Veterans G.O. Bonds are within the applicable limit for the Department.

The Federal Tax Code requires the issuer of qualified veterans' mortgage bonds to file with the Internal Revenue Service reports on the issuance of its bonds following such issuance, as well a mortgage loan information report. The Department has covenanted to file, as required, such reports with respect to the Offered Veterans G.O. Bonds.

The Federal Tax Code requires that the effective interest rate on mortgage loans financed with the lendable proceeds of qualified veterans' mortgage bonds may not exceed the yield on the issue by more than 1.125% (1.50% for pre-Ullman bonds) and that certain investment earnings on non-mortgage investments, calculated based upon the extent such investment earnings exceed the amount that would have been earned on such investments if the investments were invested at a yield equal to the yield on the issue, be rebated to the United States or to veterans for qualified veterans' mortgage bonds. The Department has covenanted to comply with these requirements and has established procedures to determine the amount of excess earnings, if any, that must be rebated to the United States or to veterans. See "THE PROGRAM—Contracts of Purchase" in Appendix B hereto for discussions of provisions of the Veterans Code which affect the Department's ability to establish and to change interest rates on Contracts of Purchase.

The Federal Tax Code states that an issuer will be treated as meeting the arbitrage restrictions on mortgage loans and the veterans provisions if it in good faith attempted to meet all such requirements and any failure to meet such requirements was due to inadvertent error after taking all reasonable steps to comply with such requirements.

*Opinions of the Attorney General and Bond Counsel*

In the opinions of the Attorney General and of Hawkins, Delafield & Wood, Bond Counsel (expected to be delivered in substantially the forms set forth in Appendix E), under existing statutes and court decisions, (i) interest on the Offered Veterans G.O. Bonds is not included in gross income for federal income tax purposes pursuant to Section 103 of the Federal Tax Code, (ii) interest on the Series BM Bonds and Series BN Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Federal Tax Code with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations, and (iii) interest on the Series BP Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Federal Tax Code with respect to individuals and corporations. The Attorney General and Bond Counsel express no opinion as to the exclusion from gross income of interest on any Offered Veterans G.O. Bond subsequent to any date on which action is taken under the Resolutions, tax certificates and other documents applicable to the issuance of the Offered Veterans G.O. Bonds (collectively, the "Documents") for which action the Documents require a legal opinion to the effect that taking such action will not adversely affect such exclusion, unless the Attorney General and such firm deliver an opinion as of such date to such effect.

Orrick, Herrington & Sutcliffe LLP, Special Counsel to the State Treasurer with respect to the Offered Veterans G.O. Bonds, has traditionally acted as Bond Counsel to the State in connection with the issuance of its general obligation bonds. Special Counsel advised the State that such firm was not prepared to render its unqualified opinion as to the exclusion of interest on the Offered Veterans G.O. Bonds if prepayments of Contracts of Purchase allocated to such Bonds were permitted to be used to make additional Contracts of Purchase ("recycling"). However, Special Counsel has advised the State that it is of the view that an opinion rendered by the Attorney General and Hawkins, Delafield & Wood on such basis (i.e., permitting recycling) is reasonable and that the State may accept it, and further that Special Counsel has participated in similar transactions as underwriters' counsel where opinions have been rendered on such basis.

*Compliance*

The Federal Tax Code imposes various restrictions, conditions and requirements relating to the exclusion from gross income for federal income tax purposes of interest on obligations such as the Offered Veterans G.O. Bonds. The State and the Department have covenanted to comply with certain restrictions applicable to the Offered Veterans G.O. Bonds, which restrictions are designed to assure that interest on the Offered Veterans G.O. Bonds will not be included in federal gross income. Failure to comply with these covenants may result in interest on the Offered Veterans G.O. Bonds being included in federal gross income retroactive to the date of issuance thereof. The opinion of the Attorney General and Bond Counsel assumes compliance with these covenants. Neither the Attorney General nor Bond Counsel has undertaken to determine (or to inform any person) whether any actions taken (or omitted) or events occurring after the date of issuance of the Offered Veterans G.O. Bonds may adversely affect the tax status of the interest on the Offered Veterans G.O. Bonds.

*Original Issue Discount*

The Attorney General and Bond Counsel are of the opinion that under existing statutes and court decisions, the excess, if any, of the principal amount payable when a maturity of Offered Veterans G.O. Bonds is scheduled to come due over the initial public offering price of such Offered Veterans G.O. Bonds constitutes original issue discount that is not included in gross income for federal income tax purposes to the same extent as interest on the Offered Veterans G.O. Bonds. For purposes of the preceding sentence, the "initial public offering price" refers to the initial offering price to the public (excluding bond houses, brokers or similar persons acting in the capacity of underwriters or wholesalers) at which a substantial amount of the Offered Veterans G.O. Bonds constituting the same maturity of such Offered Veterans G.O. Bonds was sold.

Original issue discount accrues in accordance with a constant interest method based on the compounding of interest, and an owner's adjusted basis in an Offered Veterans G.O. Bond having original issue discount (a "Discount Bond") for purposes of determining gain or loss on disposition will be increased by the amount of any such accrual. A portion of the original issue discount that accrues in each year to an owner of a Discount Bond that is a corporation will be included in the calculation of the corporation's federal alternative minimum tax liability. Consequently, corporate owners of a Discount Bond should be aware that the accrual of original issue discount in each year may result in an alternative minimum tax liability even though such owners have not received a corresponding cash payment.

Owners of Discount Bonds should consult their own tax advisors with respect to the determination for federal income tax purposes of original issue discount accrued upon sale or redemption of Discount Bonds, and with respect to the state and local tax consequences of owning Discount Bonds.

*Certain Additional Federal Tax Consequences*

The following is a brief discussion of certain additional federal income tax matters with respect to the Offered Veterans G.O. Bonds under existing statutes. It does not purport to deal with all aspects of federal taxation that may be relevant to a particular owner of an Offered Veterans G.O. Bond. Prospective investors, particularly those who may be subject to special rules, are advised to consult their own tax advisors regarding the federal tax consequences of owning and disposing of the Offered Veterans G.O. Bonds.

As noted above, interest on the Series BM Bonds and Series BN Bonds must be taken into account in determining the tax liability of corporations subject to the federal alternative minimum tax imposed by Section 55 of the Federal Tax Code, and interest on the Series BP Bonds is a preference item in determining the tax liability of individuals, corporations, and other taxpayers subject to the alternative minimum tax imposed by Section 55 of the Federal Tax Code. Interest on the Offered Veterans G.O. Bonds must also be taken into account in determining the tax liability of foreign corporations subject to the branch profits tax imposed by Section 884 of the Federal Tax Code.

Owners of Offered Veterans G.O. Bonds should be aware that the ownership of such obligations may result in collateral federal income tax consequences to various categories of persons, such as corporations (including S corporations and certain foreign corporations), financial institutions, property and casualty insurance companies, individual recipients of Social Security or Railroad Retirement benefits, and individuals otherwise eligible for the earned income tax credit and to taxpayers deemed to have incurred or continued indebtedness to purchase or carry obligations the interest on which is not included in gross income for federal income tax purposes.

Legislation affecting municipal bonds is frequently considered by the United States Congress. For example, several bills were introduced (but not enacted) during the 104th Congress to extend the environmental tax imposed by Section 59A of the Federal Tax Code with respect to taxable years beginning before January 1, 1996. There can be no assurance that legislation enacted or proposed after the date of issuance of the Offered Veterans G.O. Bonds will not have an adverse effect on the tax-exempt status or market price of the Offered Veterans G.O. Bonds.

**State Tax Matters**

The Attorney General and Bond Counsel are of the opinion that the interest on the Offered Veterans G.O. Bonds is exempt from personal income taxes of the State of California under present State law.

## LEGAL OPINIONS

The opinions of the Attorney General, and Hawkins, Delafield & Wood, Bond Counsel, approving the validity of the Offered Veterans G.O. Bonds and stating the opinions expressed under "TAX MATTERS," will be substantially in the forms set forth in Appendix E. The Attorney General and Bond Counsel undertake no responsibility for the accuracy, completeness or fairness of this Official Statement. Certain legal matters will be passed on for the Underwriters by their counsel, Kutak Rock.

## LITIGATION

There is not now pending or known to the Attorney General to be threatened any material litigation seeking to prevent the sale and delivery of the Offered Veterans G.O. Bonds or questioning the validity of the Offered Veterans G.O. Bonds. While at any given time, including the present, there are numerous civil actions pending against the State, which could, if determined adversely to the State, affect the State's expenditures and, in some cases, its revenues, the Attorney General is of the opinion that no pending actions are likely to have a material adverse effect on the State's ability to pay principal of, premium, if any, and interest on the Offered Veterans G.O. Bonds when due. See Appendix A—"THE STATE OF CALIFORNIA—Litigation." See Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The 1943 Fund" for a discussion of certain litigation which may affect the 1943 Fund.

## UNDERWRITING

The Offered Veterans G.O. Bonds are being purchased by the Underwriters listed on the front cover page. The Underwriters have jointly and severally agreed to purchase the Series BM Bonds on or about March 26, 1998 for a purchase price of $66,600,000 plus accrued interest, and in connection therewith the Department will pay a fee to the Underwriters of $535,879.59. The Underwriters have jointly and severally agreed to purchase the Series BN Bonds and Series BP Bonds on or about May 5, 1998 for a purchase price of $104,915,780 plus accrued interest, and in connection therewith the Department will pay a fee to the Underwriters of $836,528.15. The initial public offering prices of the Offered Veterans G.O. Bonds may be changed from time to time by the Underwriters.

Each purchase contract relating to the Offered Veterans G.O. Bonds provides that the Underwriters will purchase all the applicable Offered Veterans G.O. Bonds if any are purchased, and that the obligation to make such purchase is subject to certain terms and conditions set forth in such purchase contract including, among others, the approval of certain legal matters by counsel.

## FINANCIAL STATEMENTS

Attached as Exhibit 1 to Appendix A are the Audited General Purpose Financial Statements of the State for the Fiscal Year ended June 30, 1997. These statements have been examined by the State Auditor to the extent indicated in his report appearing in Appendix A. Certain unaudited financial information is also included in Appendix A.

Attached as Exhibit 1 to Appendix B are the Financial Statements for the Veterans Farm and Home Building Fund of 1943 for the years ended June 30, 1997 and 1996. These statements have been audited by Deloitte & Touche LLP, independent auditors, as indicated in their report appearing in Appendix B.

## RATINGS

The Offered Veterans G.O. Bonds have received ratings of "A1" by Moody's Investors Service ("Moody's"), "A+" by Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc. ("Standard & Poor's") and "AA-" by Fitch IBCA, Inc. ("Fitch"). An explanation of the significance and status of such credit ratings may be obtained from the rating agencies furnishing the same. There is no assurance that such ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by any such rating agencies, if in their respective judgments, circumstances so warrant. A revision or withdrawal of any such credit ratings could have an effect on the market price of the applicable Offered Veterans G.O. Bonds. After the Offered Veterans G.O. Bonds are rated, the State Treasurer intends to provide appropriate periodic credit information to the bond rating agencies to assist in maintaining the ratings on the Offered Veterans G.O. Bonds.

## ADDITIONAL INFORMATION

The purpose of this Official Statement is to supply information to prospective buyers of the Offered Veterans G.O. Bonds.

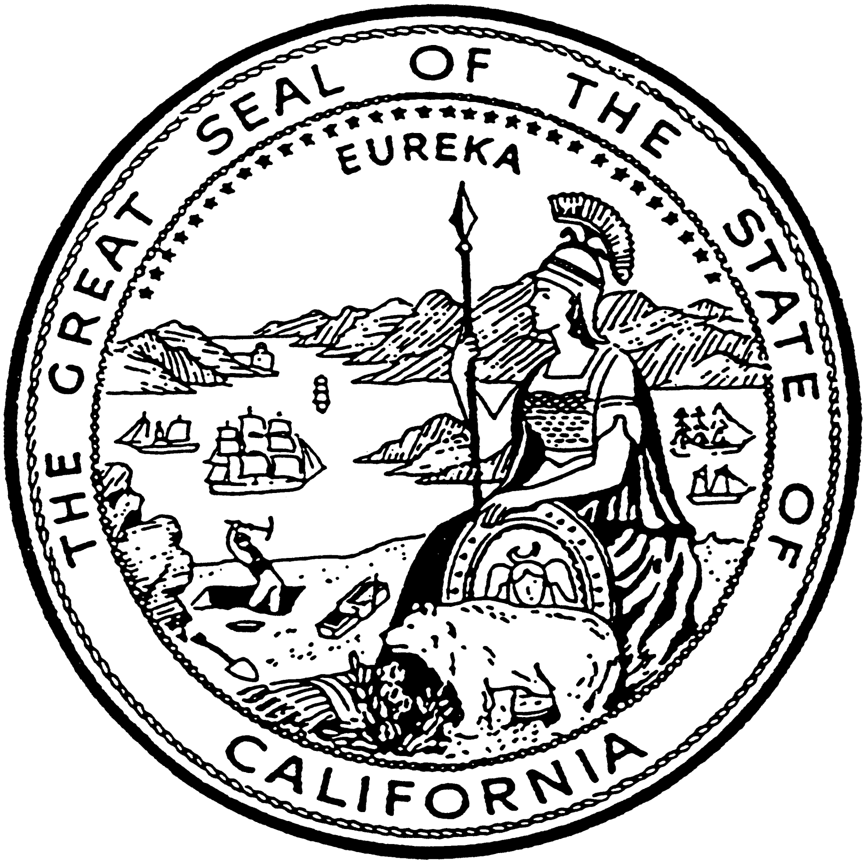
O'Brien Partners Inc. has served as Financial Advisor in connection with the issuance of the Offered Veterans G.O. Bonds. Orrick, Herrington & Sutcliffe LLP has served as Special Counsel to the State Treasurer's Office in connection with the issuance of the Offered Veterans G.O. Bonds.

All financial and statistical data contained herein have been taken or constructed from State (including Department) records, except for information expressly attributed to other sources. The presentation of information, including tables of receipts from taxes and other revenues, is intended to show recent historic information and is not intended to indicate future or continuing trends in the financial position or other affairs of the State, including the Department. No representation is made that past experience, as it might be shown by such financial and other information, will necessarily continue or be repeated in the future. Any statements made in this Official Statement involving matters of opinion, projections or estimates, whether expressly stated or not, are set forth as such and not as representations of fact.

**STATE OF CALIFORNIA**
**MATT FONG**
**Treasurer of the State of California**

APPENDIX A

# THE STATE OF CALIFORNIA




*Honorable Matt Fong*
*Treasurer of the State of California*

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## OVERVIEW OF STATE GOVERNMENT

### Organization of State Government

The State Constitution provides for three separate branches of government: the legislative, the judicial and the executive. The Constitution guarantees the electorate the right to make basic decisions, including amendments to the Constitution and local government charters. In addition, the State voters may directly influence State government through the initiative, referendum and recall processes.

California's Legislature consists of a forty-member Senate and an eighty-member Assembly. Assembly members are elected for two-year terms and Senators are elected for four-year terms. Assembly members are limited to three terms in office, and Senators to two terms. The Legislature meets almost year round for a two-year session. The Legislature employs the Legislative Analyst, who provides reports on State finances, among other subjects. The Bureau of State Audits, headed by the State Auditor, an independent office since 1993, has annually issued an auditor's report based on an examination of the General Purpose Financial Statements of the State Controller, in accordance with generally accepted accounting principles.

The Governor is the chief executive officer of the State and is elected for a four-year term. The Governor presents the annual budget and traditionally presents an annual package of bills constituting a legislative program. In addition to the Governor, State law provides for seven other statewide elected officials in the executive branch. The current elected statewide officials, their party affiliation and the dates on which they were first elected, are as follows:

| Office | Name | Party Affiliation | First Elected |
|---|---|---|---|
| Governor | Pete Wilson | Republican | 1990 |
| Lieutenant Governor | Gray Davis | Democrat | 1994 |
| Treasurer | Matt Fong | Republican | 1994 |
| Secretary of State | Bill Jones | Republican | 1994 |
| Attorney General | Daniel E. Lungren | Republican | 1990 |
| Controller | Kathleen Connell | Democrat | 1994 |
| Superintendent of Public Instruction | Delaine Eastin | Democrat | 1994 |
| Insurance Commissioner | Chuck Quackenbush | Republican | 1994 |

The current term for each office expires in January 1999. Persons elected to statewide offices are limited to two terms in office.

The executive branch is principally administered through twelve major agencies and departments: Business, Transportation and Housing Agency, Child Development and Education Agency, Environmental Protection Agency, Department of Finance, Department of Food and Agriculture, Health and Welfare Agency, Department of Industrial Relations, Resources Agency, State and Consumer Services Agency, Department of Veterans Affairs, Trade and Commerce Agency and Youth and Adult Correctional Agency. In addition, some State programs come under boards and commissions, such as The Regents of the University of California, Public Utilities Commission, Franchise Tax Board and California Transportation Commission, which have authority over many functions of State government with the power to establish policy and promulgate regulations. The appointment of members of boards and commissions is usually shared by the Legislature and the Governor, and often includes ex officio members.

California has a comprehensive system of public higher education, comprising three sectors. The highest level is the University of California, which provides undergraduate, graduate and professional degrees to about 158,000 full-time equivalent students at nine campuses. The California State University system provides undergraduate and graduate degrees to about 266,000 full-time equivalent students at 22 campuses. The third sector consists of over 100 community colleges which provide associate degrees and continuing education to over 940,000 full-time equivalent students.

**Employee Relations**

As of January, 1998, the State work force represented approximately 282,000 personnel years. Of the total, approximately 89,000 personnel years represented employees of institutions of higher education. Civil service employees who are subject to collective bargaining represent approximately 159,000 personnel years. The largest of the 21 bargaining units is the California State Employee's Association ("CSEA"), representing approximately 53 percent of those employees subject to collective bargaining.

The State Employer-Employee Relations Act, enacted in 1977, provides that State employees, defined as any civil service employee of the State and teachers under the jurisdiction of the Department of Education or the Superintendent of Public Instruction, and excluding certain other categories, have a right to form, join and participate in the activities of employee organizations for the purpose of representation on all matters of employer-employee relations. Law enforcement employees have the right to be represented separately from other employees. The chosen employee organization has the right to represent its members, except that once an employee organization is recognized as the exclusive representative of a bargaining unit, only that organization may represent employees in that unit.

The scope of representation is limited to wages, hours and other terms and conditions of employment. Representatives of the Governor are required to meet and confer in good faith and endeavor to reach agreement with the employee organization, and, if agreement is reached, to prepare a memorandum of understanding and present it to the Legislature for determination. The Governor and the recognized employee organization are authorized to agree mutually on the appointment of a mediator for the purpose of settling any disputes between the parties. Alternatively, either party could request the Public Employment Relations Board to appoint a mediator, in which case the costs of mediation would be paid by the Public Employment Relations Board.

Contracts between the State and the various employee bargaining units expire and are renegotiated periodically. As of January 1998, all collective bargaining agreements had expired and were being renegotiated. The State has not experienced any major work stoppage in the last 10 years.

## Employees' Retirement Systems

Major retirement benefit programs administered by the State are described in Note 24 to the State's Audited Financial Statements, in Exhibit 1 to Appendix A, at page 67. This note includes information on the unfunded actuarial accrued liability of all the State's major retirement programs.

The two largest programs are the Public Employees' Retirement System ("PERS") and the State Teachers' Retirement System ("STRS"). PERS had assets with a market value in excess of $119.9 billion as of June 30, 1997, an increase of $19 billion from June 30, 1996. STRS had assets with a market value in excess of $74.9 billion as of June 30, 1997, an increase of $11.5 billion from June 30, 1996.

# STATE INDEBTEDNESS

## General

The State Treasurer is responsible for the sale of debt obligations of the State and its various authorities and agencies. The State has always paid the principal of and interest on its general obligation bonds, general obligation commercial paper, lease-purchase debt and short-term obligations, including revenue anticipation notes and revenue anticipation warrants, when due.

## Capital Facilities Financing

*General Obligation Bonds* - The State Constitution prohibits the creation of general obligation indebtedness of the State unless a bond law is approved by a majority of the electorate voting at a general election or a direct primary. General obligation bond acts provide that debt service on general obligation bonds shall be appropriated annually from the General Fund and all debt service on general obligation bonds is paid from the General Fund. Under the State Constitution, debt service on general obligation bonds is the second charge to the General Fund after the application of moneys in the General Fund to the support of the public school system and public institutions of higher education. Certain general obligation bond programs receive revenues from sources other than the sale of bonds or the investment of bond proceeds.

As of January 1, 1998, the State had outstanding $18,571,476,000 aggregate principal amount of long-term general obligation bonds, and unused voter authorizations for the future issuance of $6,906,494,000 of long-term general obligation bonds. This latter figure consists of $2,667,714,000 of authorized commercial paper notes, described in the next paragraph (of which $936,220,000 had been issued), which had not yet been refunded by general obligation bonds, and $4,238,780,000 of other authorized but unissued general obligation debt. See the table "Authorized and Outstanding State Debt" below.

*Commercial Paper Program* - Pursuant to legislation enacted in 1995, voter approved general obligation indebtedness may be issued either as long-term bonds, or, for some but not all bond acts, as commercial paper notes. Commercial paper notes may be renewed or may be refunded by the issuance of long-term bonds. The State intends to issue long-term general obligation bonds from time to time to retire its general obligation commercial paper notes.

Pursuant to the terms of the bank credit agreement presently in effect supporting the general obligation commercial paper program, not more than $1.75 billion of general obligation commercial paper notes may be outstanding at any time; this amount may be increased or decreased in the future. Commercial paper notes are deemed issued upon authorization by the respective Finance Committees, whether or not such notes are actually issued. As of January 1, 1998 the Finance Committees had authorized the issuance of up to $2,667,714,000 of commercial paper notes; as of that date $936,220,000 aggregate principal amount of general obligation commercial paper notes was actually issued and outstanding.

*Lease-Purchase Debt* - In addition to general obligation bonds, the State builds and acquires capital facilities through the use of lease-purchase borrowing. Under these arrangements, the State Public Works Board, another State or local agency or a joint powers authority issues bonds to pay for the construction of facilities such as office buildings, university buildings or correctional institutions. These facilities are leased to a State agency or the University of California under a long-term lease which provides the source of payment of the debt service on the lease-purchase bonds. In some cases, there is not a separate bond issue, but a trustee directly creates certificates of participation in the State's lease obligation, which are marketed to investors. Under applicable court decisions, such lease arrangements do not constitute the creation of "indebtedness" within the meaning of the Constitutional provisions which require voter approval. For purposes of this section of the Official Statement and the tables following, "lease-purchase debt" or "lease-purchase financing" means principally bonds or certificates of participation for capital facilities where the rental payments providing the security are a direct or indirect charge against the General Fund and also includes revenue bonds for a State energy efficiency program secured by payments made by various State agencies under energy service contracts. Certain of the lease-purchase financings are supported by special funds rather than the General Fund (see "STATE FINANCES--Sources of Tax Revenue"). The table does not include equipment leases or leases which were not sold, directly or indirectly, to the public capital market. The State had $6,415,729,797 General Fund-supported lease-purchase debt outstanding at January 1, 1998. The State Public Works Board, which is authorized to sell lease revenue bonds, had $1,410,364,000 authorized and unissued as of January 1, 1998. Also, as of that date certain joint powers authorities were authorized to issue approximately $377,500,000 of revenue bonds to be secured by State leases. See Notes 8, 10, 12 and 15 to the Financial Statements, Exhibit 1 to Appendix A, for additional information on State lease commitments.

*Non-Recourse Debt* - Certain State agencies and authorities issue revenue obligations for which the General Fund has no liability. Revenue bonds represent obligations payable from State revenue-producing enterprises and projects, which are not payable from the General Fund, and conduit obligations payable only from revenues paid by private users of facilities financed by the revenue bonds. The enterprises and projects include transportation projects, various public works projects, public and private educational facilities (including the California State University and University of California systems), housing, health facilities and pollution control facilities. There are 17 agencies and authorities authorized to issue revenue obligations (excluding lease-purchase debt). State agencies and authorities had $22,495,585,453 aggregate principal amount of revenue bonds and notes which are non-recourse to the General Fund outstanding as of December 31, 1997, as further described in the table "State Agency Revenue Bonds and Conduit Financing" below.

**Cash Flow Borrowings**

As part of its cash management program, the State has regularly issued short-term obligations to meet cash flow needs. The following table shows the amount of revenue anticipation notes ("Notes") and revenue anticipation warrants ("Warrants") issued over the past five fiscal years. Between spring 1992 and summer 1994, the State had depended upon external borrowing, including borrowings extending into the subsequent fiscal year, to meet its cash needs, including repayment of maturing Notes and Warrants. The State has not had to resort to such cross-year borrowing after the 1994-95 Fiscal Year. See "STATE FINANCES--State Warrants," "PRIOR FISCAL YEARS' FINANCIAL RESULTS" and "CURRENT STATE BUDGET" below.

The State issued $3.0 billion of revenue anticipation notes for the 1997-98 Fiscal Year on September 9, 1997, which mature on June 30, 1998.

**State of California**
**Revenue Anticipation Notes and Warrants Issued**
**Fiscal Years 1993-94 to 1997-98**

| Fiscal Year | Type | Principal Amount (Billions) | Date Issued | Maturity Date |
|---|---|---|---|---|
| 1993-1994 | Notes Series A-B | $2.0 | July 28, 1993 | June 28, 1994 |
| | Warrants Series A | 1.2 | February 23, 1994 | December 21, 1994 |
| | Warrants Series B | 2.0 | February 23, 1994 | July 26, 1994 |
| 1994-1995 | Warrants Series C-D | 4.0 | July 26, 1994 | April 25, 1996 |
| | Notes Series A-C | 3.0 | August 3, 1994 | June 28, 1995 |
| 1995-1996 | Notes | 2.0 | April 25, 1996 | June 28, 1996 |
| 1996-1997 | Notes Series A-C | 3.0 | August 6, 1996 | June 30, 1997 |
| 1997-1998 | Notes | 3.0 | September 9, 1997 | June 30, 1998 |

SOURCE: State of California, Office of the Treasurer.

**Authorized and Outstanding State Debt**

The tables which follow provide information on outstanding State debt, authorized but unissued general obligation bonds and commercial paper notes, debt service requirements for State general obligation and lease-purchase bonds, and authorized and outstanding State revenue bonds. For purposes of these tables, "General Fund bonds," also known as "non-self liquidating bonds," are general obligation bonds expected to be paid from the General Fund without reimbursement from any other fund. Although the principal of general obligation commercial paper notes in the "non-self liquidating" category is legally payable from the General Fund, the State expects that principal of such commercial paper notes will be paid only from the issuance of new commercial paper notes or the issuance of long-term general obligation bonds to retire the commercial paper notes. Interest on "non-self liquidating" general obligation commercial paper notes is payable from the General Fund.

"Enterprise Fund bonds," also known as "self liquidating bonds," are general obligation bonds for which program revenues are expected to be sufficient to reimburse in full the General Fund for debt service payments, but any failure to make such a reimbursement does not affect the obligation of the State to pay principal and interest on the bonds from the General Fund.

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## OUTSTANDING STATE DEBT
## FISCAL YEARS 1992-93 THROUGH 1996-97
## (Thousands)

| | 1992-93 | 1993-94 | 1994-95 | 1995-96 | 1996-97 |
|---|---|---|---|---|---|
| **Outstanding Debt(a)** | | | | | |
| General Obligation Bonds | | | | | |
| General Fund (Non-Self Liquidating)................ | $ 13,337,721 | $ 14,368,506 | $ 14,903,326 | $ 14,322,086 | $ 14,250,536 |
| Enterprise Fund (Self Liquidating)..................... | 4,302,655 | 4,028,865 | 4,171,775 | 3,934,630 | 3,699,060 |
| Total................................................................ | $ 17,640,376 | $ 18,397,371 | $ 19,075,101 | $ 18,256,716 | $ 17,949,596 |
| Lease-Purchase Debt............................................ | 3,997,183 | 5,096,508 | 5,565,162 | 5,845,237 | 6,175,044 |
| Total Outstanding General Obligation Bonds and Lease-Purchase Debt..................... | $ 21,637,559 | $ 23,493,879 | $ 24,640,263 | $ 24,101,953 | $ 24,124,640 |
| **Bond Sales During Fiscal Year** | | | | | |
| Non-Self Liquidating General Obligation Bonds. | $ 2,617,706 | $ 2,042,665 | $ 1,505,600 | $ 620,810 | $ 1,025,000 |
| Self Liquidating General Obligation Bonds......... | $ - | $ 2,000 | $ 386,930 | $ 0 | $ 0 |
| Lease-Purchase Debt............................................ | $ 1,775,570 | $ 1,765,400 | $ 598,817 | $ 779,575 | $ 1,257,630 |
| **Debt Service(b)** | | | | | |
| Non-Self Liquidating General Obligation Bonds. | $ 1,472,581 | $ 1,748,001 | $ 1,901,265 | $ 1,960,603 | $ 1,946,333 |
| Lease-Purchase Debt............................................ | $ 276,514 | $ 364,543 | $ 425,940 | $ 482,751 | $ 532,783 |
| **General Fund Receipts(b)....................................** | $ 42,757,910 | $ 40,527,732 | $ 44,547,812 | $ 46,731,104 | $ 49,831,217 |
| Non-Self Liquidating General Obligation Bonds Debt Service as a Percentage of General Fund Receipts................................................... | 3.44% | 4.31% | 4.27% | 4.20% | 3.91% |
| Lease-Purchase Debt Service as a Percentage of General Fund Receipts............... | 0.65% | 0.90% | 0.96% | 1.03% | 1.07% |
| **Population(c)........................................................** | 31,188,000 | 31,517,000 | 31,790,000 | 32,063,000 | 32,383,000 |
| Non-Self Liquidating General Obligation Bonds Outstanding Per Capita...................................... | $ 427.66 | $ 455.90 | $ 468.81 | $ 446.69 | $ 440.06 |
| Lease-Purchase Debt Outstanding Per Capita...... | $ 128.16 | $ 161.71 | $ 175.06 | $ 182.30 | $ 190.69 |
| **Personal Income(d)..............................................** | $ 697,911,000 | $ 715,923,000 | $ 760,431,000 | $ 810,129,000 | $ 865,185,000 |
| Non-Self Liquidating General Obligation Bonds Outstanding as Percentage of Personal Income.. | 1.91% | 2.01% | 1.96% | 1.77% | 1.65% |
| Lease-Purchase Debt Outstanding as Percentage of Personal Income........................... | 0.57% | 0.71% | 0.73% | 0.72% | 0.71% |

(a) As of last day of fiscal year
(b) Calculated on a cash basis; debt service costs of bonds issued in any fiscal year largely appear in subsequent fiscal year.
(c) As of July 1, the beginning of the fiscal year.
(d) Calendar year in which fiscal year ends.

SOURCES: Population and Personal Income: State of California, Department of Finance
Outstanding Debt, Bonds Sales During Fiscal Year and Debt Service: State of California, Office of the Treasurer.
General Fund Receipts: State of California, Office of the State Controller.

## AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
### As of January 1, 1998
### (Thousands)

| | Voter Authorization Date | Voter Authorization Amount | Bonds Outstanding | CP Program Authorized (a) | Unissued (b) |
|---|---|---|---|---|---|
| **GENERAL FUND BONDS (Non-Self Liquidating)** | | | | | |
| California Earthquake Safety and Housing Rehabilitation Bond Act of 1988. | 6/7/88 | $ 150,000 | $ 95,520 | $ n.a. | $ 0 |
| California Library Construction and Renovation Bond Act of 1988 | 11/8/88 | 75,000 | 52,970 | 6,725 | 1,900 |
| California Park and Recreational Facilities Act of 1984 | 6/5/84 | 370,000 | 227,125 | n.a. | 1,100 |
| California Parklands Act of 1980 | 11/4/80 | 285,000 | 78,710 | n.a. | 0 |
| California Safe Drinking Water Bond Law of 1976 | 6/8/76 | 175,000 | 75,870 | n.a. | 2,500 |
| California Safe Drinking Water Bond Law of 1984 | 11/6/84 | 75,000 | 46,320 | n.a. | 0 |
| California Safe Drinking Water Bond Law of 1986 | 11/4/86 | 100,000 | 73,875 | n.a. | 8,000 |
| California Safe Drinking Water Bond Law of 1988 | 11/8/88 | 75,000 | 47,750 | 11,265 | 7,000 |
| California Wildlife, Coastal, and Park Land Conservation Act of 1988 | 6/7/88 | 776,000 | 564,340 | n.a. | 39,980 |
| Clean Air and Transportation Improvement Bond Act of 1990 | 6/5/90 | 1,990,000 | 1,020,290 | 161,420 | 624,300 |
| Clean Water and Water Conservation Bond Law of 1978 | 6/6/78 | 375,000 | 96,070 | n.a. | 4,150 |
| Clean Water and Water Reclamation Bond Law of 1988 | 11/8/88 | 65,000 | 41,925 | 12,505 | 0 |
| Clean Water Bond Law of 1970 | 11/3/70 | 250,000 | 7,000 | n.a. | 0 |
| Clean Water Bond Law of 1974 | 6/4/74 | 250,000 | 13,820 | n.a. | 0 |
| Clean Water Bond Law of 1984 | 11/6/84 | 325,000 | 136,635 | n.a. | 0 |
| Community Parklands Act of 1986 | 6/3/86 | 100,000 | 68,045 | n.a. | 0 |
| County Correctional Facility Capital Expenditure and Youth Facility Bond Act of 1988 | 11/8/88 | 500,000 | 362,250 | 25,000 | 0 |
| County Correctional Facility Capital Expenditure Bond Act of 1986 | 6/3/86 | 495,000 | 339,230 | n.a. | 2,000 |
| County Jail Capital Expenditure Bond Act of 1981 | 11/2/82 | 280,000 | 133,525 | n.a. | 0 |
| County Jail Capital Expenditure Bond Act of 1984 | 6/5/84 | 250,000 | 122,000 | n.a. | 0 |
| Earthquake Safety and Public Buildings Rehabilitation Bond Act of 1990 | 6/5/90 | 300,000 | 40,900 | 84,000 | 166,000 |
| Fish and Wildlife Habitat Enhancement Act of 1984 | 6/5/84 | 85,000 | 47,690 | n.a. | 3,500 |
| Hazardous Substance Cleanup Bond Act of 1984 | 11/6/84 | 100,000 | 44,600 | n.a. | 0 |
| Higher Education Facilities Bond Act of 1986 | 11/4/86 | 400,000 | 243,500 | n.a. | 0 |
| Higher Education Facilities Bond Act of 1988 | 11/8/88 | 600,000 | 410,085 | 4,705 | 7,000 |
| Higher Education Facilities Bond Act of June 1990 | 6/5/90 | 450,000 | 313,045 | 14,500 | 7,000 |
| Higher Education Facilities Bond Act of June 1992 | 6/2/92 | 900,000 | 699,235 | 59,420 | 46,700 |
| Housing and Homeless Bond Act of 1988 | 11/8/88 | 300,000 | 118,620 | n.a. | 0 |
| Housing and Homeless Bond Act of 1990 | 6/5/90 | 150,000 | 84,305 | n.a. | 0 |
| Lake Tahoe Acquisitions Bond Act | 8/2/82 | 85,000 | 51,120 | n.a. | 0 |

## AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
### (Continued)

| | Voter Authorization Date | Voter Authorization Amount | Bonds Outstanding | CP Program Authorized (a) | Unissued (b) |
|---|---|---|---|---|---|
| New Prison Construction Bond Act of 1981 | 6/8/82 | $ 495,000 | $ 175,250 | n.a. | $ 0 |
| New Prison Construction Bond Act of 1984 | 6/5/84 | 300,000 | 122,500 | n.a. | 0 |
| New Prison Construction Bond Act of 1986 | 11/4/86 | 500,000 | 324,200 | n.a. | 1,500 |
| New Prison Construction Bond Act of 1988 | 11/8/88 | 817,000 | 565,610 | 7,600 | 8,400 |
| New Prison Construction Bond Act of 1990 | 6/5/90 | 450,000 | 301,275 | 40,100 | 0 |
| Passenger Rail and Clean Air Bond Act of 1990 | 6/5/90 | 1,000,000 | 691,275 | 107,900 | 0 |
| Public Education Facilities Bond Act of 1996 | 3/26/96 | 3,000,000 | 948,750 | 1,252,805 | 784,700 |
| 1988 School Facilities Bond Act | 11/8/88 | 800,000 | 522,390 | 45,000 | 0 |
| 1990 School Faci'ities Bond Act | 6/5/90 | 800,000 | 540,780 | 34,745 | 0 |
| 1992 School Facilities Bond Act | 11/3/92 | 900,000 | 720,436 | 65,094 | 0 |
| Safe, Clean Reliable Water Supply Act of 1996 | 11/5/96 | 995,000 | 50,000 | 92,000 | 853,000 |
| Seismic Retrofit Bond Act of 1996 | 3/26/96 | 2,000,000 | 348,325 | 501,995 | 1,148,000 |
| School Building and Earthquake Bond Act of 1974 | 11/5/74 (c) | 40,000 | 38,665 | n.a. | 0 |
| School Facilities Bond Act of 1988 | 6/7/88 | 800,000 | 526,680 | n.a. | 0 |
| School Facilities Bond Act of 1990 | 11/6/90 | 800,000 | 545,770 | 55,000 | 0 |
| School Facilities Bond Act of 1992 | 6/2/92 | 1,900,000 | 1,505,050 | 65,000 | 0 |
| Senior Center Bond Act of 1984 | 11/6/84 | 50,000 | 22,250 | n.a. | 0 |
| State Beach, Park, Recreational and Historical Facilities Bonds | (d) | 250,000 | 3,850 | n.a. | 0 |
| State School Building Lease-Purchase Bond Law of 1982 | 11/2/82 | 500,000 | 145,175 | n.a. | 0 |
| State School Building Lease-Purchase Bond Law of 1984 | 11/6/84 | 450,000 | 237,500 | n.a. | 0 |
| State School Building Lease-Purchase Bond Law of 1986 | 11/4/86 | 800,000 | 506,800 | n.a. | 0 |
| State, Urban, and Coastal Park Bond Act of 1976 | 11/2/76 | 280,000 | 24,225 | n.a. | 2,450 |
| Water Conservation and Water Quality Bond Law of 1986 | 6/3/86 | 150,000 | 76,655 | n.a. | 47,000 |
| Water Conservation Bond Law of 1988 | 11/8/88 | 60,000 | 31,065 | 20,935 | 3,000 |
| **Total General Fund Bonds** | | $ 28,468,000 | $ 14,630,846 | $ 2,667,714 | $ 3,769,180 |
| **ENTERPRISE FUND BONDS (Self Liquidating)** | | | | | |
| California Water Resources Development Bond Act of 1959 | 11/8/60 | $ 1,750,000 | $ 1,036,225 | $ n.a. | $ 167,600 |
| Harbor Development Bond Law of 1958 | 11/4/58 | 60,000 | 285 | n.a. | 0 |
| State School Building Aid Bonds | (c) (d) | 460,000 | 6,250 | n.a. | 0 |
| Veterans Bonds | (d) | 5,610,000 | 2,897,870 | n.a. | 302,000 |
| **Total Enterprise Fund Bonds** | | $ 7,880,000 | $ 3,940,630 | $ 0 | $ 469,600 |
| **TOTAL GENERAL OBLIGATION BONDS** | | $ 36,348,000 | $ 18,571,476 | $ 2,667,714 | $ 4,238,780 |

(a) Total commercial paper authorized to be issued by the respective Finance Committees. Of this total $936,220,000 is outstanding as of January 1, 1998. Pursuant to terms of the Finance Committee resolutions, no more than $1.75 billion of commercial paper can be outstanding at any one time. Bond acts marked "n.a." are not legally permitted to utilize commercial paper, or all bonds were issued before the commercial paper program began.

(b) Treats full commercial paper authorization as issued; see footnote (a).

(c) Pursuant to Prop 203, passed by the voters in the March 26, 1996 primary election, $40 million in bonds unissued at that time became general fund supported, while all previously issued bonds will remain under "State School Building Aid Bonds" as self-liquidating Enterprise Bonds.

(d) Various dates.

SOURCE: State of California, Office of the Treasurer.

# SCHEDULE OF DEBT SERVICE REQUIREMENTS
# FOR GENERAL FUND GENERAL OBLIGATION BONDS(a)
## (Non-Self Liquidating)
## As of January 1, 1998

| Fiscal Year Ending June 30 | Current Debt | | |
|---|---|---|---|
| | Interest | Principal (b) | Total |
| 1998 | $ 451,957,148.38 | $ 365,900,000.00 | $ 817,857,148.38 (c) |
| 1999 | 860,101,367.48 | 1,001,055,000.00 | 1,861,156,367.48 |
| 2000 | 801,687,471.25 | 986,915,000.00 | 1,788,602,471.25 |
| 2001 | 746,051,219.25 | 980,628,068.25 | 1,726,679,287.50 |
| 2002 | 678,023,506.32 | 1,024,420,000.00 | 1,702,443,506.32 |
| 2003 | 616,158,873.89 | 973,561,391.80 | 1,589,720,265.69 |
| 2004 | 553,281,323.75 | 899,420,000.00 | 1,452,701,323.75 |
| 2005 | 500,011,270.09 | 836,154,388.71 | 1,336,165,658.80 |
| 2006 | 444,692,337.50 | 772,690,000.00 | 1,217,382,337.50 |
| 2007 | 395,024,615.77 | 727,925,000.00 | 1,122,949,615.77 |
| 2008 | 351,138,020.44 | 711,248,078.31 | 1,062,386,098.75 |
| 2009 | 304,245,681.25 | 702,960,000.00 | 1,007,205,681.25 |
| 2010 | 258,806,146.25 | 646,320,000.00 | 905,126,146.25 |
| 2011 | 220,024,441.09 | 571,344,045.16 | 791,368,486.25 |
| 2012 | 181,732,823.80 | 427,800,000.00 | 609,532,823.80 |
| 2013 | 158,118,954.60 | 317,035,000.00 | 475,153,954.60 |
| 2014 | 141,815,159.64 | 244,380,000.00 | 386,195,159.64 |
| 2015 | 128,615,810.94 | 232,855,000.00 | 361,470,810.94 |
| 2016 | 115,900,092.24 | 231,165,000.00 | 347,065,092.24 |
| 2017 | 103,380,180.93 | 230,890,000.00 | 334,270,180.93 |
| 2018 | 91,020,111.85 | 230,455,000.00 | 321,475,111.85 |
| 2019 | 78,718,343.75 | 230,005,000.00 | 308,723,343.75 |
| 2020 | 66,438,325.00 | 229,540,000.00 | 295,978,325.00 |
| 2021 | 53,875,588.75 | 229,670,000.00 | 283,545,588.75 |
| 2022 | 41,540,796.25 | 214,350,000.00 | 255,890,796.25 |
| 2023 | 29,621,159.20 | 216,380,000.00 | 246,001,159.20 |
| 2024 | 19,003,118.09 | 144,135,000.00 | 163,138,118.09 |
| 2025 | 11,479,955.58 | 104,860,000.00 | 116,339,955.58 |
| 2026 | 6,434,496.09 | 65,855,000.00 | 72,289,496.09 |
| 2027 | 2,930,327.34 | 49,215,000.00 | 52,145,327.34 |
| 2028 | 812,728.59 | 31,715,000.00 | 32,527,728.59 |
| Total | $ 8,412,641,395.35 | $ 14,630,845,972.23 | $ 23,043,487,367.58 |

(a) Does not include commercial paper outstanding.

(b) Includes scheduled mandatory sinking fund payments as well as serial maturities.

(c) Total represents the remaining debt service requirements from February 1, 1998 through June 30, 1998.

SOURCE: State of California, Office of the Treasurer.

## SCHEDULE OF DEBT SERVICE REQUIREMENTS
## FOR ENTERPRISE FUND GENERAL OBLIGATION BONDS(a)
## (Self Liquidating)
## As of January 1, 1998

| Fiscal Year Ending June 30 | Current Debt Interest | Current Debt Principal (b) | Total | |
|---|---|---|---|---|
| 1998 | $ 120,512,532.77 | $ 83,765,000.00 | $ 204,277.532.77 | (c) |
| 1999 | 236,771,051.15 | 187,145,000.00 | 423,916,051.15 | |
| 2000 | 224,074,688.65 | 200,010,000.00 | 424,084,688.65 | |
| 2001 | 210,159,943.75 | 194,790,000.00 | 404,949,943.75 | |
| 2002 | 196,365,308.75 | 198,865,000.00 | 395,230,308.75 | |
| 2003 | 182,394,498.85 | 191,725,000.00 | 374,119,498.85 | |
| 2004 | 168,918,406.25 | 184,740,000.00 | 353,658,406.25 | |
| 2005 | 155,908,686.00 | 179,030,000.00 | 334,938,686.00 | |
| 2006 | 143,310,239.75 | 161,780,000.00 | 305,090,239.75 | |
| 2007 | 131,929,298.51 | 157,610,000.00 | 289,539,298.51 | |
| 2008 | 120,199,781.05 | 155,770,000.00 | 275,969,781.05 | |
| 2009 | 108,974,755.00 | 154,440,000.00 | 263,414,755.00 | |
| 2010 | 98,187,747.80 | 151,935,000.00 | 250,122,747.80 | |
| 2011 | 88,508,248.25 | 118,020,000.00 | 206,528,248.25 | |
| 2012 | 81,436,169.75 | 137,775,000.00 | 219,211,169.75 | |
| 2013 | 74,275,536.00 | 131,525,000.00 | 205,800,536.00 | |
| 2014 | 66,913,767.50 | 126,200,000.00 | 193,113,767.50 | |
| 2015 | 60,876,415.00 | 124,795,000.00 | 185,671,415.00 | |
| 2016 | 54,471,918.75 | 129,975,000.00 | 184,446,918.75 | |
| 2017 | 48,145,205.00 | 121,420,000.00 | 169,565,205.00 | |
| 2018 | 42,305,290.00 | 100,770,000.00 | 143,075,290.00 | |
| 2019 | 35,595,391.64 | 166,155,000.00 | 201,750,391.64 | |
| 2020 | 30,204,005.00 | 48,065,000.00 | 78,269,005.00 | |
| 2021 | 27,462,670.00 | 40,840,000.00 | 68,302,670.00 | |
| 2022 | 25,050,865.00 | 36,210,000.00 | 61,260,865.00 | |
| 2023 | 22,828,342.50 | 10,680,000.00 | 33,508,342.50 | |
| 2024 | 22,223,570.00 | 28,165,000.00 | 50,388,570.00 | |
| 2025 | 20,480,180.00 | 41,470,000.00 | 61,950,180.00 | |
| 2026 | 17,864,055.00 | 44,115,000.00 | 61,979,055.00 | |
| 2027 | 15,128,576.25 | 46,975,000.00 | 62,103,576.25 | |
| 2028 | 12,379,327.50 | 8,255,000.00 | 20,634,327.50 | |
| 2029 | 11,956,667.50 | 6,840,000.00 | 18,796,667.50 | |
| 2030 | 11,506,147.50 | 9,250,000.00 | 20,756,147.50 | |
| 2031 | 10,972,887.50 | 9,795,000.00 | 20,767,887.50 | |
| 2032 | 10,408,407.50 | 10,365,000.00 | 20,773,407.50 | |
| 2033 | 5,058,863.36 | 241,365,000.00 | 246,423,863.36 | |
| Total | $ 2,893,759,444.78 | $ 3,940,630,000.00 | $ 6,834,389,444.78 | |

(a) Does not include commercial paper outstanding. Included $300 million of convertible option bonds which are subject to mandatory tender on 6/1/99.

(b) Includes scheduled mandatory sinking fund payments as well as serial maturities.

(c) Total represents the remaining debt service requirements from February 1, 1998 through June 30, 1998.

SOURCE: State of California, Office of the Treasurer.

## SCHEDULE OF DEBT SERVICE REQUIREMENTS
## FOR LEASE-PURCHASE DEBT
### As of January 1, 1998

| Fiscal Year Ending June 30 | Current Debt | | | |
|---|---|---|---|---|
| | Interest | Principal (a) | Total | |
| 1998 | $ 155,791,807.83 | $ 80,180,000.00 | $ 235,971,807.83 | (b) |
| 1999 | 343,315,195.65 | 229,980,400.38 | 573,295,596.03 | |
| 2000 | 331,703,762.22 | 275,269,962.79 | 606,973,725.01 | |
| 2001 | 318,403,072.31 | 296,739,019.75 | 615,142,092.06 | |
| 2002 | 304,322,520.46 | 275,935,773.02 | 580,258,293.48 | |
| 2003 | 293,188,822.28 | 276,081,118.58 | 569,269,940.86 | |
| 2004 | 278,516,680.24 | 283,401,386.24 | 561,918,066.48 | |
| 2005 | 265,006,581.10 | 296,119,507.20 | 561,126,088.30 | |
| 2006 | 246,727,415.46 | 314,247,554.60 | 560,974,970.06 | |
| 2007 | 234,868,697.79 | 265,923,920.44 | 500,792,618.23 | |
| 2008 | 217,502,678.81 | 271,991,787.98 | 489,494,466.79 | |
| 2009 | 206,634,016.93 | 291,997,732.44 | 498,631,749.37 | |
| 2010 | 185,254,314.02 | 278,421,633.76 | 463,675,947.78 | |
| 2011 | 158,941,615.82 | 288,525,000.00 | 447,466,615.82 | |
| 2012 | 143,066,546.44 | 269,460,000.00 | 412,526,546.44 | |
| 2013 | 128,113,352.52 | 275,025,000.00 | 403,138,352.52 | |
| 2014 | 112,972,221.08 | 274,860,000.00 | 387,832,221.08 | |
| 2015 | 97,515,907.85 | 290,520,000.00 | 388,035,907.85 | |
| 2016 | 81,572,077.71 | 267,640,000.00 | 349,212,077.71 | |
| 2017 | 66,631,493.20 | 268,415,000.00 | 335,046,493.20 | |
| 2018 | 52,131,136.59 | 278,620,000.00 | 330,751,136.59 | |
| 2019 | 37,625,180.56 | 232,345,000.00 | 269,970,180.56 | |
| 2020 | 25,135,792.38 | 207,055,000.00 | 232,190,792.38 | |
| 2021 | 15,288,736.77 | 145,135,000.00 | 160,423,736.77 | |
| 2022 | 7,261,671.23 | 118,005,000.00 | 125,266,671.23 | |
| 2023 | 2,601,663.15 | 58,590,000.00 | 61,191,663.15 | |
| 2024 | 271,065.63 | 2,515,000.00 | 2,786,065.63 | |
| 2025 | 93,267.50 | 2,730,000.00 | 2,823,267.50 | |
| Total | $ 4,310,457,293.53 | $ 6,415,729,797.18 | $ 10,726,187,090.71 | |

(a) Includes scheduled mandatory sinking fund payments as well as serial maturities.
(b) Total represents the remaining debt service requirements from February 1, 1998 through June 30, 1998

SOURCE: State of California, Office of the Treasurer.

**STATE PUBLIC WORKS BOARD AND**
**OTHER LEASE-PURCHASE FINANCING**
**OUTSTANDING ISSUES**
**As of January 1, 1998**

| Name of Issue | Outstanding |
|---|---|
| **GENERAL FUND SUPPORTED ISSUES:** | |
| **State Public Works Board** | |
| California Community Colleges | $ 658,220,000 |
| Department of Corrections * | 2,722,908,684 |
| Energy Efficiency Program (Various State Agencies) (a) | 149,245,000 |
| The Regents of The University of California * (b) | 1,164,611,113 |
| Trustees of The California State University | 768,920,000 |
| Various State Office Buildings | 330,475,000 |
| **Total State Public Works Board Issues** | **$ 5,794,379,797** |
| **Total Other State Building Lease Purchase Issues** | **$ 621,350,000** |
| **Total General Fund Supported Issues** | **$ 6,415,729,797** |
| **SPECIAL FUND SUPPORTED ISSUES:** | |
| East Bay State Building Authority Certificates of Participation (State of California Department of Transportation) * | $ 95,920,101 |
| San Bernardino Joint Powers Financing Authority (State of California Department of Transportation) | 63,755,000 |
| San Francisco State Building Authority (State of California Department of General Services Lease) (c) | 54,270,000 |
| **Total Special Fund Supported Issues** | **$ 213,945,101** |
| **TOTAL** | **$ 6,629,674,898** |

* Includes the initial value of capital appreciation bonds rather than the accreted value.
(a) This program is self-liquidating based on energy cost savings.
(b) The Regents' obligations to the State Public Works Board are payable from lawfully available funds of The Regents which are held in The Regents' treasury funds and are separate from the State General Fund. A portion of The Regents' annual budget is derived from General Fund appropriations.
(c) The sole tenant is the California Public Utilities Commission.

SOURCE: State of California, Office of the Treasurer.

## STATE AGENCY REVENUE BONDS
## AND CONDUIT FINANCING
### For the quarter ending December 31, 1997

| Issuing Agency | Outstanding(a) |
|---|---|
| **State Programs Financing:** | |
| California State University | $ 369,873,000 |
| California Transportation Commission | 43,750,000 |
| Department of Water Resources | 2,441,060,000 |
| The Regents of the University of California | 2,397,555,000 |
| Trade and Commerce Agency | 2,475,000 |
| **Housing Financing:** | |
| California Housing Finance Agency | 5,240,440,461 |
| Veterans Revenue Debenture | 294,430,000 |
| **Conduit Financing:** | |
| California Alternative Energy and Advanced Transportation Financing Authority | 59,785,000 |
| California Economic Development Financing Authority | 158,801,502 |
| California Educational Facilities Authority | 1,761,439,294 |
| California Health Facilities Financing Authority | 4,910,116,196 |
| California Infrastructure and Economic Development Bank Authority | -- |
| California Passenger Rail Financing Commission | -- |
| California Pollution Control Financing Authority | 4,766,895,000 |
| California School Finance Authority | 15,645,000 |
| California Student Loan Authority | 30,260,000 |
| California Urban Waterfront Area Restoration Financing Authority | 3,060,000 |
| **TOTAL** | **$ 22,495,585,453** |

(a) Total Outstanding does not include defeased bonds and includes the accreted values for capital appreciation bonds.

SOURCE: State of California, Office of the Treasurer.

# STATE FINANCES

## The Budget Process

The State's fiscal year begins on July 1 and ends on June 30. The State operates on a budget basis, using a modified accrual system of accounting, with revenues credited in the period in which they are measurable and available and expenditures debited in the period in which the corresponding liabilities are incurred.

The annual budget is proposed by the Governor by January 10 of each year for the next fiscal year (the "Governor's Budget"). Under State law, the annual proposed Governor's Budget cannot provide for projected expenditures in excess of projected revenues and balances available from prior fiscal years. Following the submission of the Governor's Budget, the Legislature takes up the proposal.

Under the State Constitution, money may be drawn from the Treasury only through an appropriation made by law. The primary source of the annual expenditure authorizations is the Budget Act as approved by the Legislature and signed by the Governor. The Budget Act must be approved by a two-thirds majority vote of each House of the Legislature. The Governor may reduce or eliminate specific line items in the Budget Act or any other appropriations bill without vetoing the entire bill. Such individual line-item vetoes are subject to override by a two-thirds majority vote of each House of the Legislature.

Appropriations also may be included in legislation other than the Budget Act. Bills containing appropriations (except for K-14 education) must be approved by a two-thirds majority vote in each House of the Legislature and be signed by the Governor. Bills containing K-14 education appropriations only require a simple majority vote. Continuing appropriations, available without regard to fiscal year, may also be provided by statute or the State Constitution.

Funds necessary to meet an appropriation need not be in the State Treasury at the time such appropriation is enacted; revenues may be appropriated in anticipation of their receipt.

## The General Fund

The moneys of the State are segregated into the General Fund and approximately 800 Special Funds, including Bond, Trust and Pension Funds. The General Fund consists of revenues received by the State Treasury and not required by law to be credited to any other fund, as well as earnings from the investment of State moneys not allocable to another fund. The General Fund is the principal operating fund for the majority of governmental activities and is the depository of most of the major revenue sources of the State. For additional financial data relating to the General Fund, see Exhibits 1 and 2 to this Appendix A. The General Fund may be expended as a consequence of appropriation measures enacted by the Legislature and approved by the Governor, as well as appropriations pursuant to various constitutional authorizations and initiative statutes.

**The Special Fund for Economic Uncertainties**

The Special Fund for Economic Uncertainties ("SFEU") is funded with General Fund revenues and was established to protect the State from unforeseen revenue reductions and/or unanticipated expenditure increases. Amounts in the SFEU may be transferred by the State Controller as necessary to meet cash needs of the General Fund. The State Controller is required to return moneys so transferred without payment of interest as soon as there are sufficient moneys in the General Fund.

The legislation creating the SFEU contains a continuous appropriation from the General Fund authorizing the State Controller to transfer to the SFEU, as of the end of each fiscal year, the lesser of (i) the unencumbered balance in the General Fund and (ii) the difference between the State's "appropriations subject to limitation" for the fiscal year then ended and its "appropriations limit" as defined in Section 8 of Article XIII B of the State Constitution and established in the Budget Act for that fiscal year, as jointly estimated by the State's Legislative Analyst's Office and the Department of Finance. For a further description of Article XIII B, see "State Appropriations Limit" below. In certain circumstances, moneys in the SFEU may be used in connection with disaster relief.

For budgeting and accounting purposes, any appropriation made from the SFEU is deemed an appropriation from the General Fund. For year-end reporting purposes, the State Controller is required to add the balance in the SFEU to the balance in the General Fund so as to show the total moneys then available for General Fund purposes.

In the Governor's Budget for Fiscal Year 1998-99, released on January 9, 1998, the Department of Finance projects the SFEU will have a balance of about $329 million at June 30, 1998. See "CURRENT STATE BUDGET" below.

**Inter-Fund Borrowings**

Inter-fund borrowing has been used for many years to meet temporary imbalances of receipts and disbursements in the General Fund. As of June 30, 1997, the General Fund had outstanding loans from the SFEU, General Fund Special Accounts and certain Special Funds in the amount of $1.190 billion.

In the event the General Fund is or will be exhausted, the State Controller is required to notify the Governor and the Pooled Money Investment Board (the "PMIB," consisting of the State Director of Finance, the State Treasurer and the State Controller). The Governor may then order the State Controller to direct the transfer of all or any part of the moneys not needed in Special Funds to the General Fund from such Special Funds, as determined by the PMIB. All money so transferred must be returned to the Special Fund from which it was transferred as soon as there is sufficient money in the General Fund to do so. Transfers cannot be made from a Special Fund which will interfere with the objective for which such Special Fund was created, or from certain specific funds. When moneys transferred to the General Fund in any fiscal year from any Special Fund pursuant to the inter-fund borrowing mechanism exceed ten percent of the total additions as shown in the statement of operations of the preceding fiscal year as set forth in the Budgetary (Legal Basis) annual report of the State Controller, interest must be paid on such excess at a rate determined by the PMIB to be the current earning rate of the Pooled Money Investment Account.

Although any determination of whether a proposed borrowing from one of the Special Funds is permissible, any such determination must be made with regard to the facts and circumstances existing at the time of the proposed borrowing. The Attorney General of the State has identified certain criteria relevant to such a determination. For instance, amounts in the Special Funds eligible for inter-fund borrowings are legally available to be transferred to the General Fund if a reasonable estimate of expected General Fund revenues, based upon legislation already enacted, indicates that such transfers can be paid from the General Fund promptly if needed by the Special Funds or within a short period of time if not needed. In determining whether this requirement has been met, the Attorney General has stated that consideration may be given to the fact that General Fund revenues are projected to exceed expenditures entitled to a higher priority than payment of internal transfers, i.e., expenditures for the support of the public school system and public institutions of higher education and the payment of debt service on general obligation bonds of the State. Any reduction in internal borrowable resources may increase the State's reliance on external borrowing to meet its cash flow requirements.

The following chart shows General Fund internal borrowable resources on June 30 of each of the Fiscal Years 1993-94 through 1996-97 and estimates for 1997-98:

**General Fund Internal Borrowable Resources**
**(Cash Basis)**
**(Millions)**

| | June 30, | | | | |
|---|---|---|---|---|---|
| | 1994 | 1995 | 1996 | 1997 | 1998 |
| Available Internal Borrowable Resources | $6,500.4 | $5,376.0 | $5,211.0 | $6,242.2 | $6,132.2 |
| Outstanding Loans | | | | | |
| From Special Fund for Economic Uncertainties | -0- | -0- | 20.3 | 281.2* | 117.7 |
| From Special Funds and Accounts | 4,015.0 | -0- | 1,433.7 | 909.2 | 1,951.9 |
| Total Outstanding Internal Loans | 4,015.0 | -0- | 1,454.0 | 1,190.4 | 2,069.6 |
| Unused Internal Borrowable Resources† | $2,485.4 | $5,376.0 | $3,757.0 | $5,051.8 | $4,062.6 |

* Department of Finance estimates are slightly different because they are made using the budgetary basis of accounting. See "CURRENT STATE BUDGET" below.

† In addition, the State had external borrowings represented by Revenue Anticipation Warrants, in the following amounts at the following dates: June 30, 1994: $3.2 billion; June 30, 1995: $4.0 billion. See "STATE INDEBTEDNESS–Cash Flow Borrowings."

SOURCE: State of California, Office of the State Controller. Information for the Fiscal Years ended June 30, 1994 through 1997 are actual figures. For the year ending June 30, 1998, this figure was estimated as of December 23, 1997.

**Investment of Funds**

Moneys on deposit in the State's Centralized Treasury System are invested by the Treasurer in the Pooled Money Investment Account (the "PMIA"). As of December 31, 1997, the PMIA held approximately $17.9 billion of State moneys, and $10.9 billion of moneys invested for about 2,541 local governmental entities through the Local Agency Investment Fund ("LAIF"). The assets of the PMIA as of December 31, 1997 are shown in the following table:

**Analysis of the Pooled Money Investment Account Portfolio**

| Type of Security | Amount (Millions) | Percent Of Total |
|---|---|---|
| U.S. Treasury Bills and Notes | $7,307.0 | 25.4% |
| Commercial Paper (corporate) | 7,281.9 | 25.3 |
| Certificates of Deposits | 6,497.9 | 22.6 |
| Corporate Bonds | 1,451.9 | 5.0 |
| Federal Agency Securities | 2,694.2 | 9.4 |
| Bankers Acceptances | 321.6 | 1.1 |
| Bank Notes | 930.0 | 3.2 |
| Loans Per Government Code | 1,431.0 | 5.0 |
| Time Deposits | 1,072.8 | 3.7 |
| Repurchases | --- | 0 |
| Reverse Repurchases | (197.3) | (0.7) |
| | $28,790.8* | 100.0% |

*Total may not add due to rounding.
SOURCE: State of California, Office of the Treasurer.

The State's treasury operations are managed in compliance with the California Government Code and according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. The PMIA operates with the oversight of the Pooled Money Investment Board (consisting of the State Treasurer, the State Controller and the Director of Finance). The LAIF portion of the PMIA operates with the oversight of the Local Agency Investment Advisory Board (consisting of the State Treasurer and four other appointed members).

The Treasurer does not invest in leveraged products or inverse floating rate securities. The investment policy permits the use of reverse repurchase agreements subject to limits of no more than 10 percent of the PMIA. All reverse repurchase agreements are cash matched either to the maturity of the reinvestment or an adequately positive cash flow date which is approximate to the maturity of the reinvestment.

The average life of the investment portfolio of the PMIA as of December 31, 1997 was 201 days.

## State Warrants

No money may be drawn from the State Treasury except upon a warrant duly issued by the State Controller. The State Controller is obligated to draw every warrant on the fund out of which it is payable for the payment of money directed by State law to be paid out of the State Treasury; however, a warrant may not be drawn unless authorized by law and unless unexhausted specific appropriations provided by law are available to meet it. State law provides two methods for the State Controller to respond if the General Fund has insufficient "Unapplied Money" available to pay a warrant when it is drawn, referred to generally as "registered warrants" and "reimbursement warrants." "Unapplied Money" consists of money in the General Fund for which outstanding warrants have not already been drawn and which would remain in the General Fund if all outstanding warrants previously drawn and then due were paid. Unapplied Money may include moneys transferred to the General Fund from the SFEU and internal borrowings from the Special Funds (to the extent permitted by law).

If a warrant is drawn on the General Fund for an amount in excess of the amount of Unapplied Money in the General Fund, after deducting from such Unapplied Money the amount, as estimated by the State Controller, required by law to be set apart for obligations having priority over obligations to which such warrant is applicable, the warrant must be registered by the State Treasurer on the reverse side as not paid because of the shortage of funds in the General Fund. The State Controller then delivers such a "registered warrant" to persons or entities (e.g., employees, suppliers and local governments) otherwise entitled to receive payments from the State. A registered warrant bears interest at a rate designated by the PMIB up to a maximum of 5 percent per annum. Registered warrants have no fixed maturity date, but are redeemed when the Controller, with the approval of the PMIB, determines there would be sufficient Unapplied Money in the General Fund. The State Controller notifies the State Treasurer, who publishes a notice that the warrants in question are payable.

In lieu of issuing individual registered warrants to numerous creditors, there is an alternative procedure whereby the Governor, upon request of the State Controller, may create a General Cash Revolving Fund in the State Treasury which may borrow from other State special funds to meet payments authorized by law. The State Controller may then issue "reimbursement warrants" at competitive bid to reimburse the General Cash Revolving Fund, thereby increasing cash resources for the General Fund to cover required payments. The General Cash Revolving Fund is created solely to facilitate the issuance of registered reimbursement warrants. Reimbursement warrants have a fixed maturity date, and must be paid by the State Treasurer on their maturity date from any Unapplied Money in the General Fund and available therefor.

See "PRIOR FISCAL YEARS' FINANCIAL RESULTS" below and "STATE INDEBTEDNESS--Short-Term Borrowings" above for a discussion of warrants issued by the State in recent years to meet the State's cash needs.

## Welfare Reform

Congress passed and the President signed (on August 22, 1996) the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193, the "Law") making a fundamental reform of the nation's welfare system. Among many provisions, the Law includes: (i) conversion of Aid to Families with Dependent Children from an entitlement program to a block grant titled Temporary Assistance for Needy Families (TANF), with lifetime time limits on TANF recipients, work requirements and other changes; (ii) provisions denying certain federal welfare and public benefits to legal noncitizens (this provision was recently changed by a federal law), allowing states to elect to deny additional benefits (including TANF) to legal noncitizens, and generally denying almost all benefits to illegal immigrants; and (iii) changes in the Food Stamp program, including reducing maximum benefits and imposing work requirements.

As part of the 1997-98 Budget Act legislative package, the Legislature and Governor agreed on a comprehensive reform of the State's public assistance programs to implement the new federal law. The new basic State welfare program is called California Work Opportunity and Responsibility to Kids Act ("CalWORKs"), which replaces the former Aid to Families with Dependent Children (AFDC) and Greater Avenues to Independence (GAIN) programs effective January 1, 1998. Consistent with the federal law, CalWORKs contains new time limits on receipt of welfare aid, both lifetime as well as for any current period on aid. The centerpiece of CalWORKs is the linkage of eligibility to work participation requirements. Administration of the new Welfare-to-Work programs will be largely at the county level, and counties are given financial incentives for success in this program.

Although the longer-term impact of the new federal Law and CalWORKs cannot be determined until there has been more experience, the State does not presently anticipate that these new programs will have an adverse financial impact on the General Fund. Overall TANF grants from the federal government are expected to equal or exceed the amounts the State would have received under the old AFDC program.

**Local Governments**

The primary units of local government in California are the counties, ranging in population from 1,200 in Alpine County to almost 9,500,000 in Los Angeles County. Counties are responsible for the provision of many basic services, including indigent health care, welfare, courts, jails and public safety in unincorporated areas. There are also about 480 incorporated cities, and thousands of other special districts formed for education, utility and other services. The fiscal condition of local governments has been constrained since the enactment of "Proposition 13" in 1978, which reduced and limited the future growth of property taxes, and limited the ability of local governments to impose "special taxes" (those devoted to a specific purpose) without two-thirds voter approval. Counties, in particular, have had fewer options to raise revenues than many other local government entities, and have been required to maintain many services.

The entire statewide welfare system has been changed in response to the change in federal welfare law enacted in 1996 (see "Welfare Reform" above). Under the CalWORKs program, counties are given flexibility to develop their own plans, consistent with State law, to implement the program and to administer many of its elements, and their costs for administrative and supportive services are capped at the 1996-97 levels. Counties are also given financial incentives if, at the individual county level or statewide, the CalWORKs program produces savings associated with specified standards. Counties will still be required to provide "general assistance" aid to certain persons who cannot obtain welfare from other programs.

Historically, funding for the State's trial court system was divided between the State and the counties. However, Chapter 850, Statutes of 1997, implements a restructuring of the State's trial court funding system. In 1997-98, funding for the courts, with the exception of costs for facilities, local judicial benefits, and revenue collection, was consolidated at the State level. The county contribution for both their general fund and fine and penalty amounts is capped at the 1994-95 level and becomes part of the Trial Court Trust Fund, which supports all trial court operations. The State assumes responsibility for future growth in trial court funding. This consolidation is intended to streamline the operation of the courts, provide a dedicated revenue source, and relieve fiscal pressure on the counties.

In the aftermath of Proposition 13, the State provided aid from the General Fund to make up some of the loss of property tax moneys, including taking over the principal responsibility for funding K-12 schools and community colleges. During the recent recession, the Legislature eliminated most of the remaining components of post-Proposition 13 aid to local government entities other than K-14 education districts, although it has also provided additional funding sources (such as sales taxes) and reduced certain mandates for local services. Since then the State has also provided additional funding to counties and cities through such programs as health and welfare realignment, trial court restructuring, the COPs program supporting local public safety departments, and various other measures.

On November 5, 1996, voters approved Proposition 218, entitled the "Right to Vote on Taxes Act," which incorporates new Articles XIIIC and XIIID into the California Constitution. These new provisions place limitations on the ability of local government agencies to impose or raise various taxes, fees, charges and assessments without voter approval. Certain "general taxes" imposed after January 1, 1995 must be approved by voters in order to remain in effect. In addition, Article XIIIC clarifies the right of local voters to reduce taxes, fees, assessments or charges through local initiatives. There are a number of ambiguities concerning the Proposition and its impact on local governments and their bonded debt which will require interpretation by the courts or the Legislature. Proposition 218 does not affect the State or its ability to levy or collect taxes.

**State Appropriations Limit**

The State is subject to an annual appropriations limit imposed by Article XIII B of the State Constitution (the "Appropriations Limit"). The Appropriations Limit does not restrict appropriations to pay debt service on the Bonds or other voter-authorized bonds.

Article XIII B prohibits the State from spending "appropriations subject to limitation" in excess of the Appropriations Limit. "Appropriations subject to limitation," with respect to the State, are authorizations to spend "proceeds of taxes," which consist of tax revenues, and certain other funds, including proceeds from regulatory licenses, user charges or other fees to the extent that such proceeds exceed "the cost reasonably borne by that entity in providing the regulation, product or service," but "proceeds of taxes" exclude most state subventions to local governments, tax refunds and some benefit payments such as unemployment insurance. No limit is imposed on appropriations of funds which are not "proceeds of taxes," such as reasonable user charges or fees and certain other non-tax funds.

Not included in the Appropriations Limit are appropriations for the debt service costs of bonds existing or authorized by January 1, 1979, or subsequently authorized by the voters, appropriations required to comply with mandates of courts or the federal government, appropriations for qualified capital outlay projects, appropriations of revenues derived from any increase in gasoline taxes and motor vehicle weight fees above January 1, 1990 levels, and appropriation of certain special taxes imposed by initiative (e.g., cigarette and tobacco taxes). The Appropriations Limit may also be exceeded in cases of emergency.

The State's Appropriations Limit in each year is based on the limit for the prior year, adjusted annually for changes in State per capita personal income and changes in population, and adjusted, when applicable, for any transfer of financial responsibility of providing services to or from another unit of government. The measurement of change in population is a blended average of statewide overall population growth, and change in attendance at local school and community college ("K-14") districts. The Appropriations Limit is tested over consecutive two-year periods. Any excess of the aggregate "proceeds of taxes" received over such two-year period above the combined Appropriations Limits for those two years is divided equally between transfers to K-14 districts and refunds to taxpayers.

The Legislature has enacted legislation to implement Article XIII B which defines certain terms used in Article XIII B and sets forth the methods for determining the Appropriations Limit. California Government Code Section 7912 requires an estimate of the Appropriations Limit to be included in the Governor's Budget, and thereafter to be subject to the budget process and established in the Budget Act.

The following table shows the State's Appropriations Limit for the past four fiscal years and the current fiscal year. In the Governor's Budget for Fiscal Year 1998-99 released January 9, 1998, the Department of Finance projects the State's Appropriations Subject to Limitations will be $7.7 billion under the State's Appropriations Limit in Fiscal Year 1998-99.

**State Appropriations Limit**
**(Millions)**

| | Fiscal Years | | | | |
|---|---|---|---|---|---|
| | 1993-94 | 1994-95 | 1995-96 | 1996-97 | 1997-98 |
| State Appropriations Limit | $36,599 | $37,554 | $39,309 | $42,002 | $44,778 |
| Appropriations Subject to Limit | (30,050) | (31,621) | (34,186) | (35,103) | (38,446) |
| Amount (Over)/Under Limit | $ 6,549 | $ 5,933 | $ 5,123 | $ 6,899 | $ 6,332 |

SOURCE: State of California, Department of Finance.

**Proposition 98**

On November 8, 1988, voters of the State approved Proposition 98, a combined initiative constitutional amendment and statute called the "Classroom Instructional Improvement and Accountability Act." Proposition 98 changed State funding of public education below the university level and the operation of the State Appropriations Limit, primarily by guaranteeing K-14 schools a minimum share of General Fund revenues. Under Proposition 98 (as modified by Proposition 111, which was enacted on June 5, 1990), K-14 schools are guaranteed the greater of (a) in general, a fixed percent of General Fund revenues ("Test 1"), (b) the amount appropriated to K-14 schools in the prior year, adjusted for changes in the cost of living (measured as in Article XIII B by reference to State per capita personal income) and enrollment ("Test 2"), or (c) a third test, which would replace Test 2 in any year when the percentage growth in per capita General Fund revenues from the prior year plus one half of one percent is less than the percentage growth in State per capita personal income ("Test 3"). Under Test 3, schools would receive the amount appropriated in the prior year adjusted for changes in enrollment and per capita General Fund revenues, plus an additional small adjustment factor. If Test 3 is used in any year, the difference between Test 3 and Test 2 would become a "credit" to schools which would be the basis of payments in future years when per capita General Fund revenue growth exceeds per capita personal income growth. Legislation adopted prior to the end of the 1988-89 Fiscal Year, implementing Proposition 98, determined the K-14 schools' funding guarantee under Test 1 to be 40.3 percent of the General Fund tax revenues, based on 1986-87 appropriations. However, that percent has been adjusted to approximately 35 percent to account for a subsequent redirection of local property taxes, since such redirection directly affects the share of General Fund revenues to schools.

Proposition 98 permits the Legislature by two-thirds vote of both houses, with the Governor's concurrence, to suspend the K-14 schools' minimum funding formula for a one-year period. Proposition 98 also contains provisions transferring certain State tax revenues in excess of the Article XIII B limit to K-14 schools (see "STATE FINANCES--State Appropriations Limit" above).

During the recent recession, General Fund revenues for several years were less than originally projected, so that the original Proposition 98 appropriations turned out to be higher than the minimum percentage provided in the law. The Legislature responded to these developments by designating the "extra" Proposition 98 payments in one year as a "loan" from future years' Proposition 98 entitlements, and also intended that the "extra" payments would not be included in the Proposition 98 "base" for calculating future years' entitlements. By implementing these actions, per-pupil funding from Proposition 98 sources stayed almost constant at approximately $4,200 from Fiscal Year 1991-92 to Fiscal Year 1993-94.

In 1992, a lawsuit was filed, called *California Teachers' Association v. Gould*, which challenged the validity of these off-budget loans. The settlement of this case, finalized in July, 1996, provides, among other things, that both the State and K-14 schools share in the repayment of prior years' emergency loans to schools. Of the total $1.76 billion in loans, the State will repay $935 million by forgiveness of the amount owed, while schools will repay $825 million. The State share of the repayment will be reflected as an appropriation above the current Proposition 98 base calculation. The schools' share of the repayment will count as appropriations that count toward satisfying the Proposition 98 guarantee, or from "below" the current base. Repayments are spread over the eight-year period of 1994-95 through 2001-02 to mitigate any adverse fiscal impact.

Substantially increased General Fund revenues, above initial budget projections, in the fiscal years 1994-95 and thereafter have resulted or will result in retroactive increases in Proposition 98 appropriations from subsequent fiscal years' budgets. Because of the State's increasing revenues, per-pupil funding at the K-12 level has increased by about 22% from the level in place from 1991-92 through 1993-94, and is estimated at about $5,150 per ADA in 1997-98. A significant amount of the "extra" Proposition 98 monies in the last few years have been allocated to special programs, most particularly an initiative to allow each classroom from grades K-3 to have no more than 20 pupils by the end of the 1997-98 school year. There are also new initiatives for reading skills and to upgrade technology in high schools. See "CURRENT STATE BUDGET" for further discussion of education funding.

**Sources of Tax Revenue**

The following is a summary of the State's major revenue sources. Further information on State revenues is contained under "CURRENT STATE BUDGET" and "STATE FINANCES -- Recent Tax Receipts" below.

*Personal Income Tax*

The California personal income tax, which in 1996-97 contributed about 47 percent of General Fund revenues, is closely modeled after the federal income tax law. It is imposed on net taxable income (gross income less exclusions and deductions). The tax is progressive with rates ranging from 1 to 9.3 percent. Personal, dependent and other credits are allowed against the gross tax liability. In addition, taxpayers may be subject to an alternative minimum tax ("AMT") which is much like the federal AMT.

The personal income tax is adjusted annually by the change in the consumer price index to prevent taxpayers from being pushed into higher tax brackets without a real increase in income.

*Sales Tax*

The sales tax is imposed upon retailers for the privilege of selling tangible personal property in California. Sales tax accounted for about 34 percent of General Fund revenue in 1996-97. Most retail sales and leases are subject to the tax. However, exemptions have been provided for certain essentials such as food for home consumption, prescription drugs, gas delivered through mains and electricity. Other exemptions provide relief for a variety of sales ranging from custom computer software to aircraft.

The breakdown of the 7.25 percent rate currently imposed on a statewide basis is:

- 5.00 percent represents the State General Fund tax rate.
- 2.00 percent is dedicated to cities and counties.
- 0.25 percent is dedicated to county transit systems.

Legislation in July 1991 raised the sales tax rate by 1.25 percent to its current level. Of this amount, 0.25 percent was added to the General Fund tax rate, and the balance was dedicated to cities and counties. One-half percent was a permanent addition to counties, but with the money earmarked to trust funds to pay for health and welfare programs whose administration was transferred to counties. Another 0.5 percent of the State General Fund tax rate that was scheduled to terminate after June 30, 1993 was extended until December 31, 1993 and allocated to local agencies for public safety programs. Voters in a special election on November 2, 1993 approved a constitutional amendment to permanently extend this 0.5 percent sales tax for local public safety programs.

Currently, 0.25 percent of the State tax rate may be terminated upon certification by the Director of Finance that the balance in the budget reserve for two consecutive years will exceed 4 percent of General Fund revenues. The 0.25 percent rate can be reinstated if the Director of Finance subsequently determines that the reserve will not exceed 4 percent of General Fund revenues.

*Bank and Corporation Tax*

Bank and corporation tax revenues, which comprised about 12 percent of General Fund revenue in 1996-97, are derived from the following taxes:

1. The franchise tax and the corporate income tax are levied at an 8.84 percent rate on profits. The former is imposed on corporations for the privilege of doing business in California, while the latter is imposed on corporations that derive income from California sources but are not sufficiently present to be classified as doing business in the State.

2. Banks and other financial corporations are subject to the franchise tax plus an additional tax at the rate of 2.0 percent on their net income. This additional tax is in lieu of personal property taxes and business license taxes.

3. The alternative minimum tax (AMT) is similar to that in federal law. In general, the AMT is based on a higher level of net income computed by adding back certain tax preferences. This tax is imposed at a rate of 6.65 percent.

4. Sub-Chapter S corporations are taxed at 1.5 percent of profits.

*Insurance Tax*

The majority of insurance written in California is subject to a 2.35 percent gross premium tax. For insurers, this premium tax takes the place of all other State and local taxes except those on real property and motor vehicles. Exceptions to the 2.35 percent rate are certain pension and profit-sharing plans which are taxed at the lesser rate of 0.50 percent, surplus lines and nonadmitted insurance at 3 percent and ocean marine insurers at 5 percent of underwriting profits. Insurance taxes comprised approximately 2.4 percent of General Fund revenues in 1996-97.

In November, 1988, voters approved Proposition 103, which mandated reductions and rebates for certain property and casualty insurance premiums. The measure also directed the State Board of Equalization to adjust the gross premiums tax rate to compensate for any resultant decrease in insurance tax revenue through the 1990 tax year. As a result, the State Board of Equalization increased the gross premiums tax rate from 2.35 percent to 2.37 percent for the 1989 tax year and to 2.46 percent for the 1990 tax year. For 1991 and beyond, the rate returned to 2.35 percent. Implementation of the offset rates used for Proposition 103 resulted in a lawsuit, which has now been settled. The Board of Equalization indicates all claims from this case have been paid by the State.

In December, 1996, the California Earthquake Authority (CEA) was authorized to start selling homeowners' earthquake insurance. Earthquake policies written through the CEA are exempt from the gross premiums tax.

*Other Taxes*

Other General Fund major taxes and licenses include: Estate, Inheritance and Gift Taxes, Cigarette Taxes, Alcoholic Beverage Taxes, Horse Racing Revenues and trailer coach license fees. These other sources totaled approximately 2.3 percent of General Fund Revenues in the 1996-97 Fiscal Year.

*Special Fund Revenues*

The California Constitution, codes and statutes specify the uses of certain revenue. Such receipts are accounted for in various Special Funds. In general, Special Fund revenues comprise three categories of income:

1. Receipts from tax levies which are allocated to specified functions, such as motor vehicle taxes and fees and certain taxes on tobacco products.

2. Charges for special services to specific functions, including such items as business and professional license fees.

3. Rental royalties and other receipts designated for particular purposes (e.g., oil and gas royalties).

Motor vehicle related taxes and fees accounted for about 59 percent of all Special Fund revenue in 1996-97. Principal sources of this income are motor vehicle fuel taxes, registration and weight fees and vehicle license fees. During the 1996-97 Fiscal Year, $8.0 billion was derived from the ownership or operation of motor vehicles. About $4.5 billion of this revenue was returned to local governments. The remainder was available for various State programs related to transportation and services to vehicle owners. These amounts (as well as those shown below in the table "Comparative Yield of State Taxes--All Funds") include the additional fees and taxes derived from the passage of Proposition 111 in June 1990.

On November 8, 1988, voters approved Proposition 99, which imposed, as of January 1, 1989, an additional 25 cents per pack excise tax on cigarettes, and a new, equivalent excise tax on other tobacco products. The initiative requires that funds from this tax be allocated to anti-tobacco education and research and indigent health services, and environmental and recreation programs. See Note 22 to the State's Audited Financial Statements for the year ended June 30, 1997 for a discussion of certain litigation concerning Proposition 99 funding. Legislation enacted in 1993 added an additional 2 cents per pack excise tax for the purpose of funding breast cancer research.

### Recent Tax Receipts

The following table shows the trend of major General Fund and total taxes per capita and per $100 of personal income for the past five years and the current and upcoming fiscal years.

**Trend of State Taxes**

| Fiscal Year | Taxes per Capita(a) | | Taxes per $100 of Personal Income | |
|---|---|---|---|---|
| | General Fund | Total | General Fund | Total |
| 1992-93 | $1,256.80 | $1,546.43 | $5.70 | $7.02 |
| 1993-94 | 1,216.84 | 1,552.84 | 5.46 | 6.97 |
| 1994-95 | 1,292.83 | 1,593.21 | 5.69 | 7.01 |
| 1995-96 | 1,398.03 | 1,710.51 | 5.86 | 7.17 |
| 1996-97(p) | 1,480.87 | 1,802.03 | 5.94 | 7.22 |
| 1997-98(b) | 1,572.66 | 1,900.51 | 5.98 | 7.23 |
| 1998-99(b) | 1,630.40 | 1,964.41 | 5.94 | 7.15 |

(a) Data reflect population figures benchmarked to the 1990 Census.
(b) Estimated.
(p) Preliminary.

SOURCE: State of California, Department of Finance.

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The following table gives the actual and estimated growth in revenues by major source for the last five years and the current and upcoming fiscal years.

## COMPARATIVE YIELD OF STATE TAXES—ALL FUNDS 1992-93 THROUGH 1998-99 (Modified Accrual Basis) (Thousands of Dollars)

| Year Ending June 30 | Sales and Use(a)(b) | Personal Income | Bank and Corporation(c) | Tobacco(d) | Inheritance, Estate and Gift(e) | Insurance(f) | Alcoholic Beverages(g) | Motor Vehicle Fuel(h) | Motor Vehicle Fees(i) |
|---|---|---|---|---|---|---|---|---|---|
| 1993 | 16,598,863(j) | 17,358,751(k) | 4,659,950 | 677,846 | 458,433 | 1,188,181 | 292,107 | 2,412,574 | 4,470,321 |
| 1994 | 16,857,369 | 17,402,976(k) | 4,809,273 | 664,322 | 552,139 | 1,196,921 | 275,797 | 2,547,633 | 4,518,795 |
| 1995 | 17,758,933 | 18,608,181(k) | 5,685,618 | 674,727 | 595,238 | 998,868 | 268,957 | 2,685,731 | 4,749,594 |
| 1996 | 19,088,313 | 20,877,687(k) | 5,862,420 | 666,779 | 659,338 | 1,131,737 | 269,227 | 2,757,289 | 5,009,319 |
| 1997 | 20,111,743 | 23,275,990 | 5,788,414 | 665,415 | 599,255 | 1,199,554 | 271,065 | 2,824,589 | 5,260,355 |
| 1998(l) | 19,519,601 | 25,980,000 | 5,835,301 | 650,800 | 731,000 | 1,224,000 | 269,500 | 2,907,366 | 5,436,756 |
| 1999(l) | 20,355,703 | 27,640,000 | 6,175,000 | 640,500 | 762,000 | 1,281,000 | 267,600 | 2,994,122 | 5,658,191 |

(a) Beginning in 1994-95, includes "Realignment Portion" which is transferred to local governments.

(b) Beginning in 1994-95, the State Controller numbers include local tax revenue from the 0.5 percent rate increase that the voters passed in November 1993, for local public safety services. The estimates, however, do not include the voter approved local revenue.

(c) Includes the corporation income tax and, from 1993 through 1997, the unitary election fee.

(d) Proposition 99, of 1988, increased the cigarette tax to $0.35 per pack and added an equivalent tax to other tobacco products. The Breast Cancer Act added $0.02 per pack effective January 1, 1994.

(e) Proposition 6, of 1982, repealed the inheritance and gift taxes and imposed an estate tax equal to the maximum allowable Federal estate tax credit, effective for decedents dying on or after June 8, 1982.

(f) The conclusion of litigation resulted in additional revenue of $51 million in 1987-88, $178 million in 1988-89, $7 million in 1990-91, and $5 million in 1991-92. It also resulted in refunds of $46 million in 1993-94, $127 million in 1994-95, $39 million in 1995-96, $15 million in 1996-97, and will result in additional refunds in 1997-98.

(g) Alcoholic beverage excise taxes were significantly increased effective July 15, 1991.

(h) Motor vehicle fuel tax (gasoline), use fuel tax (diesel and other fuels), and jet fuel.

(i) Registration and weight fees, motor vehicle license fees and other fees.

(j) Reflects 0.5 percent temporary sales tax increase between July 1, 1991 and June 30, 1993, which was transferred to local governments after July 1, 1993.

(k) Reflects temporary increase in top marginal rate to 11 percent, which reverted to 9.3 percent for tax years after January 1, 1996.

(l) Estimated. See "CURRENT STATE BUDGET."

SOURCE:

1992-93 through 1996-97: State of California, Office of the State Controller.

1997-98 through 1998-99: State of California, Department of Finance.

## State Expenditures

The following table summarizes the major categories of State expenditures, including both General Fund and Special Fund programs.

**GOVERNMENTAL COST FUNDS**
**(Budgetary Basis)**
**Schedule of Expenditures by Function and Character**
**1992-93 to 1996-97 Fiscal Years**
**(Thousands)**

| | 1992-93 | 1993-94 | 1994-95 | 1995-96 | 1996-97 |
|---|---|---|---|---|---|
| Function | | | | | |
| Legislative, Judicial, Executive | | | | | |
| Legislative | $ 170,061 | $ 175,792 | $ 180,769 | $ 187,768 | $ 196,642 |
| Judicial | 756,527 | 616,862 | 635,916 | 704,112 | 716,712 |
| Executive | 556,620 | 564,997 | 653,583 | 691,264 | 961,025 |
| State and Consumer Services | 567,778 | 630,515 | 697,555 | 749,368 | 734,238 |
| Business, Transportation and Housing | | | | | |
| Business and Housing | 402,439 | 224,217 | 225,398 | 243,185 | 115,089 |
| Transportation | 3,177,866 | 3,363,335 | 3,188,749 | 3,334,648 | 3,650,506 |
| Trade and Commerce | 24,992 | 34,122 | 47,595 | 51,280 | 63,789 |
| Resources | 1,078,435 | 1,088,492 | 1,141,488 | 1,179,481 | 1,310,074 |
| Environmental Protection | 346,786 | 510,274 | 459,492 | 505,206 | 507,156 |
| Health and Welfare | 15,728,495 | 15,953,388 | 16,675,380 | 17,275,117 | 17,987,919 |
| Correctional Programs | 2,693,576 | 3,074,471 | 3,280,762 | 3,638,672 | 3,606,674 |
| Education | | | | | |
| Education–K through 12 | 15,699,317 | 13,820,462 | 14,973,978 | 16,773,927 | 19,916,015 |
| Higher Education | 5,344,174 | 4,951,535 | 5,436,640 | 5,844,282 | 6,599,573 |
| General Government | | | | | |
| General Administration | 824,387 | 1,015,089 | 1,000,650 | 672,935 | 743,024 |
| Debt Service | 1,627,492 | 1,802,833 | 2,189,529 | 2,153,682 | 2,048,475 |
| Tax Relief | 811,558 | 473,707 | 480,430 | 474,179 | 454,509 |
| Shared Revenues | 3,113,325 | 3,162,558 | 3,188,090 | 3,346,240 | 3,690,512 |
| Miscellaneous | (87,124) | (129,338) | (92,508) | 202,158 | 133,309 |
| Expenditure Adjustment for Encumbrances | 154,566 | (162,958) | 694,288 | (7,691) | (190,609) |
| Credits for Overhead Services by General Fund | (182,689) | (184,336) | (156,118) | (130,016) | (147,019) |
| Statewide Indirect Cost Recoveries | (37,432) | (35,399) | (31,132) | (48,730) | (23,307) |
| Total | $52,771,149 | $50,950,618 | $54,870,534 | $57,841,067 | $63,074,306 |
| Character | | | | | |
| State Operations | $14,657,902 | $15,322,082 | $16,403,401 | $17,341,247 | $17,924,850 |
| Local Assistance | 37,696,530 | 35,166,791 | 37,680,952 | 39,973,320 | 44,686,447 |
| Capital Outlay | 416,717 | 461,745 | 786,181 | 526,500 | 463,009 |
| Total | $52,771,149 | $50,950,618 | $54,870,534 | $57,841,067 | $63,074,306 |

SOURCE: State of California, Office of the State Controller.

## PRIOR FISCAL YEARS' FINANCIAL RESULTS

### Fiscal Years Prior to 1995-96

Pressures on the State's budget in the late 1980's and early 1990's were caused by a combination of external economic conditions (including a recession which began in 1990) and growth of the largest General Fund Programs – K-14 education, health, welfare and corrections – at rates faster than the revenue base. During this period, expenditures exceeded revenues in four out of six years up to 1992-93, and the State accumulated and sustained a budget deficit approaching $2.8 billion at its peak at June 30, 1993. Between the 1991-92 and 1994-95 Fiscal Years, each budget required multibillion dollar actions to bring projected revenues and expenditures into balance, including significant cuts in health and welfare program expenditures; transfers of program responsibilities and funding from the State to local governments; transfer of about $3.6 billion in annual local property tax revenues from other local governments to local school districts, thereby reducing State funding for schools under Proposition 98; and revenue increases (particularly in the 1991-92 Fiscal Year budget), most of which were for a short duration.

Despite these budget actions, the effects of the recession led to large, unanticipated budget deficits. By the 1993-94 Fiscal Year, the accumulated deficit was so large that it was impractical to budget to retire it in one year, so a two-year program was implemented, using the issuance of revenue anticipation warrants to carry a portion of the deficit over the end of the fiscal year. When the economy failed to recover sufficiently in 1993-94, a second two-year plan was implemented in 1994-95, again using cross-fiscal year revenue anticipation warrants to partly finance the deficit into the 1995-96 fiscal year. See "STATE INDEBTEDNESS – Cash Flow Borrowings" above.

Another consequence of the accumulated budget deficits, together with other factors such as disbursement of funds to local school districts "borrowed" from future fiscal years and hence not shown in the annual budget, was to significantly reduce the State's cash resources available to pay its ongoing obligations. When the Legislature and the Governor failed to adopt a budget for the 1992-93 Fiscal Year by July 1, 1992, which would have allowed the State to carry out its normal annual cash flow borrowing to replenish its cash reserves, the State Controller issued registered warrants to pay a variety of obligations representing prior years' or continuing appropriations, and mandates from court orders. See "STATE FINANCES – State Warrants" above. Available funds were used to make constitutionally-mandated payments, such as debt service on bonds and warrants. Between July 1 and September 4, 1992, when the budget was adopted, the State Controller issued a total of approximately $3.8 billion of registered warrants.

For several fiscal years during the recession, the State was forced to rely on external debt markets to meet its cash needs, as a succession of notes and revenue anticipation warrants were issued in the period from June 1992 to July 1994, often needed to pay previously maturing notes or warrants. These borrowings were used also in part to spread out the repayment of the accumulated budget deficit over the end of a fiscal year, as noted earlier. The last and largest of these borrowings was $4.0 billion of revenue anticipation warrants which were issued in July, 1994 and matured on April 25, 1996. See "STATE INDEBTEDNESS – Cash Flow Borrowings" above.

**1995-96 and 1996-97 Fiscal Years**

The State's financial condition improved markedly during the 1995-96 and 1996-97 fiscal years, with a combination of better than expected revenues, slowdown in growth of social welfare programs, and continued spending restraint based on the actions taken in earlier years. The State's cash position also improved, and no external deficit borrowing has occurred over the end of these two fiscal years.

The economy grew strongly during these fiscal years, and as a result, the General Fund took in substantially greater tax revenues (around $2.2 billion in 1995-96 and $1.6 billion in 1996-97) than were initially planned when the budgets were enacted. These additional funds were largely directed to school spending as mandated by Proposition 98, and to make up shortfalls from reduced federal health and welfare aid. The accumulated budget deficit from the recession years was finally eliminated. In the Governor's 1998-99 Budget Proposal, released January 9, 1998, the Department of Finance reported that the State's budget reserve (the SFEU) totaled $461 million as of June 30, 1997.

## CURRENT STATE BUDGET

*The discussion below of the 1997-98 Fiscal Year budget, the proposed 1998-99 Fiscal Year budget and the table under "Summary of State Revenues and Expenditures" are based on estimates and projections of revenues and expenditures for the current and upcoming fiscal years and must not be construed as statements of fact. These estimates and projections are based upon various assumptions as of January 1998, which may be affected by numerous factors, including future economic conditions in the State and the nation, and there can be no assurance that the estimates will be achieved. See "CURRENT STATE BUDGET -- Revenue and Expenditure Assumptions" below.*

Periodic reports on revenues and/or expenditures during the fiscal year are issued by the Administration, the State Controller's Office and the Legislative Analyst's Office. The Department of Finance issues a monthly Bulletin which reports the most recent revenue receipts as reported by state departments, comparing them to Budget projections. The Administration also formally updates its budget projections three times during each fiscal year, in January, May, and at budget enactment.

**1997-98 Fiscal Year**

*Background*

On January 9, 1997, the Governor released his proposed budget for the 1997-98 Fiscal Year (the "Proposed Budget"). The Proposed Budget estimated General Fund revenues and transfers of about $50.7 billion, and proposed expenditures of $50.3 billion. In May 1997, the Department of Finance increased its revenue estimate for the upcoming fiscal year by $1.3 billion, in response to the continued strong growth in the State's economy.

In May, 1997, action was taken by the California Supreme Court in an ongoing lawsuit, *PERS v. Wilson*, described in "LITIGATION" below, which made final a judgment against the

State requiring an immediate payment from the General Fund to the Public Employees Retirement Fund ("PERF") to make up certain deferrals in annual retirement fund contributions which had been legislated in earlier years for budget savings, and which the courts found to be unconstitutional. On July 30, 1997, following a direction from the Governor, the Controller transferred $1.228 billion from the General Fund to the PERF in satisfaction of the judgment, representing the principal amount of the improperly deferred payments from 1995-96 and 1996-97.

In late 1997, the plaintiffs filed a claim with the State Board of Control for payment of interest under the Court rulings in an amount of $308 million. The Department of Finance has recommended approval of this claim. If approved by the Board of Control, the claim would become part of a claims bill to be paid in the 1998-99 Fiscal Year.

*Fiscal Year 1997-98 Budget Act*

Once the pension payment of $1.228 billion eliminated essentially all the "increased" revenue in the budget, final agreement was reached within a few weeks on a welfare reform package and the remainder of the budget. The Legislature passed the Budget Bill on August 11, 1997, along with numerous related bills to implement its provisions. On August 18, 1997, the Governor signed the Budget Act, but vetoed approximately $314 million of specific spending items, primarily in health and welfare and education areas from both the General Fund and Special Funds. Most of this spending (approximately $200 million) was restored in later legislation passed before the end of the Legislative Session.

The Budget Act anticipated General Fund revenues and transfers of $52.5 billion (a 6.8 percent increase over the final 1996-97 amount), and expenditures of $52.8 billion (an 8.0 percent increase from the 1996-97 levels). The Budget Act also included Special Fund expenditures of $14.4 billion (as against estimated Special Fund revenues of $14.0 billion), and $2.1 billion of expenditures from various Bond Funds. Following enactment of the Budget Act, the State implemented its normal annual cash flow borrowing program, issuing $3.0 billion of notes which mature on June 30, 1998.

The following were major features of the 1997-98 Budget Act:

1. For the second year in a row, the Budget contained a large increase in funding for K-14 education under Proposition 98, reflecting strong revenues which exceeded initial budgeted amounts. Part of the nearly $1.75 billion in increased spending was allocated to prior fiscal years. Funds were provided to fully pay for the cost-of-living-increase component of Proposition 98, and to extend the class size reduction and reading initiatives. See "STATE FINANCES - Proposition 98" above.

2. The Budget Act reflected the $1.228 billion pension case judgment payment, and brought funding of the State's pension contribution back to the quarterly basis which existed prior to the deferral actions which were invalidated by the courts.

3. Funding from the General Fund for the University of California and California State University was increased by about 6 percent ($121 million and $107 million, respectively), and there was no increase in student fees.

4. Because of the effect of the pension payment, most other State programs were continued at 1996-97 levels, adjusted for caseload changes.

5. Health and welfare costs were contained, continuing generally the grant levels from prior years, as part of the initial implementation of the new CalWORKs program.

6. Unlike prior years, this Budget Act did not depend on uncertain federal budget actions. About $300 million in federal funds, already included in the federal FY 1997 and 1998 budgets, was included in the Budget Act, to offset incarceration costs for illegal aliens.

7. The Budget Act contained no tax increases, and no tax reductions. The Renters Tax Credit was suspended for another year, saving approximately $500 million.

At the end of the Legislative Session on September 13, 1997, the Legislature passed and the Governor later signed several bills encompassing a coordinated package of fiscal reforms, mostly to take effect after the 1997-98 Fiscal Year. Included in the package were a variety of phased-in tax cuts, conformity with certain provisions of the federal tax reform law passed earlier in the year, and reform of funding for county trial courts, with the State to assume greater financial responsibility. The Department of Finance estimates that the major impact of these fiscal reforms will occur in Fiscal Year 1998-99 and subsequent years.

The Department of Finance released updated estimates for the 1997-98 Fiscal Year on January 9, 1998 as part of the Governor's 1998-99 Fiscal Year Budget Proposal. Total revenues and transfers are projected at $52.9 billion, up approximately $360 million from the Budget Act projection. Expenditures for the fiscal year are expected to rise approximately $200 million above the original Budget Act, to $53.0 billion. The balance in the budget reserve, the SFEU, is projected to be $329 million at June 30, 1998, compared to $461 million at June 30, 1997.

**Proposed 1998-99 Fiscal Year Budget**

On January 9, 1998, the Governor released his Budget Proposal for the 1998-99 Fiscal Year (the "Governor's Budget"). The Governor's Budget projects total General Fund revenues and transfers of $55.4 billion, a $2.5 billion increase (4.7 percent) over revised 1997-98 revenues. This revenue increase takes into account reduced revenues of approximately $600 million from the 1997 tax cut package, but also assumes approximately $500 million additional revenues primarily associated with capital gains realizations. The Governor's Budget notes, however, that capital gains activity and the resultant revenues derived from it are very hard to predict.

Total General Fund expenditures for 1998-99 are recommended at $55.4 billion, an increase of $2.4 billion (4.5 percent) above the revised 1997-98 level. The Governor's Budget includes funds to pay the interest claim relating to the court decision on pension fund payments, PERS v. Wilson (see "1997-98 Fiscal Year" above). The Governor's Budget projects that the

State will carry out its normal intra-year cash flow external borrowing in 1998-99, in an estimated amount of $3.0 billion. The Governor's Budget projects that the budget reserve, the SFEU, will be $296 million at June 30, 1999, slightly lower than the projected level at June 30, 1998 PERS liability.

The Governor's Budget projects Special Fund revenues of $14.7 billion, and Special Fund expenditures of $15.2 billion, in the 1998-99 Fiscal Year. A total of $3.2 billion of bond fund expenditures are also proposed.

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## Summary of State Revenues and Expenditures

**STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE–GENERAL FUND (Budgetary Basis)(a) FISCAL YEARS 1993-94 THROUGH 1997-98 (Millions)**

| | 1993-94 | 1994-95 | 1995-96 | 1996-97 | Estimated[b] 1997-98 |
|---|---|---|---|---|---|
| **Fund Balance–Beginning of Period** | $(2,240.0) | $ (1,004.8) | $ (393.8) | 1,073.9 | 639.8 |
| Restatements | | | | | |
| Prior Year Revenue, Transfer Accrual Adjustments | 159.2 | (217.3) | (5.3) | (59.0) | 1.7 |
| Prior Year Expenditure, Accrual Adjustments | (88.4) | 431.2 | 118.9 | 88.8 | 264.5 |
| Adjustment to Prior Year Debt Service | 247.9 | – | – | – | – |
| Adjustment to Prior Year Reserve for Article XVI, Section 8 of the State Constitution (Proposition 98) | – | (261.2)[c] | – | – | – |
| **Fund Balance–Beginning of Period, as Restated** | $ (1,921.3) | $ (1,052.2) | $ (280.2) | 1,103.7 | 906.0 |
| Revenues | $ 39,422.4 | $ 42,375.3 | $ 46,082.1 | $ 49,161.4 | $ 52,740.2 |
| Other Financing Sources | | | | | |
| Transfers from Other Funds | 568.7 | 1,641.3[e] | 4,540.8[f] | 181.5 | 149.4 |
| Other Additions | 55.8 | 71.8 | 61.4 | 49.3 | – |
| **Total Revenues and Other Sources** | $ 40,046.9 | $ 44,088.4 | $ 50,684.3 | $ 49,392.2 | $ 52,889.6 |
| Expenditures | | | | | |
| State Operations | $ 10,034.5 | $ 10,972.5 | $ 11,687.7 | $ 12,151.5 | $ 14,008.1 |
| Local Assistance | 28,846.2[d] | 30,958.3 | 33,132.5 | 37,433.8 | 38,923.2 |
| Capital Outlay | – | 9.5 | 28.9 | 53.5 | 90.5 |
| Other Uses | | | | | |
| Transfer to Other Funds | 249.7 | 1,489.7[e] | 4,481.1[f] | 217.3[g] | –[g] |
| **Total Expenditures and Other Uses** | $ 39,130.4 | $ 43,430.1 | $ 49,330.2 | $ 49,856.1 | $ 53,021.8 |
| **Revenues and Other Sources Over or (Under) Expenditures and Other Uses** | $ 916.5 | $ 658.3 | $ 1,354.1 | $ (463.9) | $ (132.2) |
| Fund Balance | | | | | |
| Reserved for Encumbrances | $ 316.0 | $ 306.3 | $ 450.8 | $ 442.4 | $ 445.0 |
| Reserved for Unencumbered Balances of Continuing Appropriations[h] | 51.2 | 145.7 | 123.0 | 68.1 | – |
| Reserved for Article XVI, Section 8 of the State Constitution[c] (Proposition 98) | 261.2 | – | – | – | |
| Reserved for School Loans[i] | – | 1,709.7 | 1,609.7 | 1,459.7 | 1,259.7 |
| Unreserved–Undesignated[j] | $ (1,633.2) | $ (2,555.5) | (1,109.6) | (1,330.4) | (930.9) |
| **Fund Balance–End of Period** | $ (1,004.8)[k] | $ (393.8)[k] | $ 1,073.9 | $ 639.8 | $ 773.8 |

Footnotes on following page.

SOURCE: Fiscal Years 1993-94 to 1996-97: State of California, Office of the State Controller.
Fiscal Year 1997-98: State of California, Department of Finance.

(a) These statements have been prepared on a budgetary basis in accordance with State law and some modifications would be necessary in order to comply with generally accepted accounting principles ("GAAP"). See Exhibit 1 to this Appendix A for the audited general purpose financial statements of the State for the year ended June 30, 1997, prepared in accordance with generally accepted accounting principles. See Note 2 to the Financial Statements for a description of the differences between the budgetary basis and the GAAP basis of accounting.

(b) Estimates are shown net of reimbursements and abatements.

(c) Prior to the 1994-95 fiscal year, the unencumbered and reverted balances of certain appropriations that were restricted for future educational purposes were reserved within the fund balance of the General Fund. Beginning with the 1994-95 fiscal year, a liability will be recognized for the amount that previously had been reflected as the "Reserved for Article XVI, Section 8 of the State Constitution." This change in accounting treatment is being made in order to match expenditures with the K-14 schools' share of General Fund revenues, as computed in accordance with Proposition 98. The effect of the change is to decrease the beginning fund balance of the General Fund by $261 million.

(d) The 1993-94 Budget Act contained a "repayment" in 1993-94 for a "loan" of $190 million of Proposition 98 funds in 1992-93. See "STATE FINANCES - Proposition 98" above.

(e) $1.2 billion was transferred from the General Fund to the Deficit Retirement Fund in two installments on specified dates in the 1994-95 fiscal year. On December 21, 1994, the $1.2 billion was transferred back to the General Fund from the Deficit Retirement Fund to pay and redeem at maturity $1.2 billion of 1994 Revenue Anticipation Warrants, Series A.

(f) $4.2 billion was transferred from the General Fund to the Warrant Payment Fund in four installments on specified dates in the 1995-96 fiscal year. On April 25, 1996, the $4.2 billion was transferred back to the General Fund from the Warrant Payment Fund to pay and redeem at maturity $4.0 billion of 1994 Revenue Anticipation Warrants, Series C and D.

(g) "Transfer to Other Funds" is included either in the expenditure totals detailed above or as "Transfer from Other Funds."

(h) Pursuant to Chapter 1238, Statutes of 1990, the unencumbered balances of continuing appropriations which exist when no commitment for an expenditures is made should be an item of disclosure, but the amount shall not be deducted from the fund balance. Accordingly, the General Fund condition included in the 1998-99 Governor's Budget includes the unencumbered balances of continuing appropriations as a footnote to the statement (including $409.0 million in 1996-97, $106.7 million in 1997-98 and $50.6 million in 1998-99). However, the State Controller's financial statements continue to reflect a specific reserve for the unencumbered balance for continuing appropriations.

(i) During 1995, a reserve was established in the General Fund fund balance for the $1.7 billion of previously recorded school loans which had been authorized by Chapter 703, Statutes of 1992 and Chapter 66, Statutes of 1993. These loans are deferred and are to be repaid from future General Fund appropriations. See "STATE FINANCES - Proposition 98" above for a discussion of the settlement of the CTA v. Gould lawsuit. This accounting treatment is consistent with the State's audited financial statements prepared in accordance with GAAP.

(j) Includes Special Fund for Economic Uncertainties (SFEU). The Department of Finance estimates an SFEU balance of $329 million on June 30, 1998.

(k) The 1993-94 Budget Act contained a plan to retire the projected $2.8 billion accumulated deficit over an 18-month period, to December, 1994, in part by using external borrowing in the form of revenue anticipation warrants. See "STATE INDEBTEDNESS – Cash Flow Borrowing" above. The 1994-95 Budget Act reflected a further deferral of $1.025 billion of accumulated deficit to the 1995-96 Fiscal Year. These plans are not reflected in this table.

**Revenue and Expenditure Assumptions**

The table below presents the Department of Finance's budget basis (accrual) statements of major General Fund revenue sources and expenditures for the 1996-97 Fiscal Year and estimated for the 1997-98 Fiscal Year.

**Revenues**
**(Millions)**

| Source | Actual Fiscal Year 1996-97† | Original Fiscal Year 1997-98† | Revised Fiscal Year 1997-1998†† |
|---|---|---|---|
| Personal Income Tax | $23,273 | $25,522 | $25,980 |
| Sales and Use Tax | 16,566 | 17,330 | 17,545 |
| Bank and Corporation Tax | 5,787 | 6,028 | 5,835 |
| Insurance Tax | 1,200 | 1,219 | 1,224 |
| All Other | 2,394 | 2,432 | 2,306 |
| Total Revenues and Transfers | $49,220 | $52,531 | $52,890 |

**Expenditures**
**(Millions)**

| Function | Actual Fiscal Year 1996-1997† | Original Fiscal Year 1997-98† | Revised Fiscal Year 1997-1998†† |
|---|---|---|---|
| K-12 Education | $19,983 | $21,963 | $22,452 |
| Health and Welfare | 14,848 | 14,857 | 14,697 |
| Higher Education | 6,180 | 6,610 | 6,640 |
| Youth and Adult Correctional | 3,805 | 4,032 | 4,074 |
| Legislative, Judicial and Executive | 1,552 | 1,637(a) | 1,548(a) |
| Tax Relief | 451 | 461 | 461 |
| Resources | 772 | 714 | 725 |
| State and Consumer Services | 368 | 390 | 394 |
| Business, Transportation and Housing | 298 | 270 | 277 |
| All Other | 831 | 1,893(b) | 1,754(b) |
| Total Expenditures | $49,088 | $52,827 | $53,022 |

(a) Includes expenditure of fine and penalty revenue for support of Trial Courts.
(b) Includes $1.2 billion for payment to Public Employees Retirement Fund in response to legal judgment.

† 1997-98 Budget Act.
†† Governor's Budget, January 9, 1998.

SOURCE: State of California, Department of Finance.

The Revenue and Expenditure assumptions set forth above (as well as those upon which the Governor's Budget for 1998-99 was developed) have been based upon certain estimates of the performance of the California and national economies in calendar years 1997 and 1998. In the Governor's Budget released on January 9, 1998, the Department of Finance projects that the California economy will continue to show robust growth through 1998, although at a slower pace than in 1997. The economic expansion is marked by strong growth in high technology manufacturing and services, including computer software, electronic manufacturing and motion picture/television production; growth is also strong in other business services, both nonresidential and residential construction and local education. The Asian economic crisis developing in late 1997 is expected to have some dampening effects on the State's economy, as exports to the region will be reduced further (declines had appeared already in the first half of 1997) and the trade deficit will increase. However, some impacts of the Asian situation could benefit the State, as services will be needed to handle imports, and lower interest rates should help the construction industry. Furthermore, exports to other regions, such as Mexico and elsewhere in Latin America, have grown rapidly, taking up some of the slack from Asia. The Department set out the following estimates for California economic performance which were used in predicting revenues and expenditures for the 1997-98 and 1998-99 Fiscal Year Budgets; also set forth are the Department's most recent previous estimates as set forth in the May Revision to the 1997-98 Governor's Budget, released May 14, 1997.

**Economic Assumptions**

| | For 1997 | | For 1998 | |
|---|---|---|---|---|
| | May Revision | Governor's Budget | May Revision | Governor's Budget |
| Nonfarm wage and salary employment (000) | 13,154 | 13,141 | 13,450 | 13,506 |
| Percent Change | 3.0 | 3.1 | 2.3 | 2.8 |
| Personal income ($ billions) | 865.2 | 866.0 | 917.7 | 920.6 |
| Percent Change | 6.8 | 7.2 | 6.1 | 6.3 |
| Housing Permits (Units 000) | 110 | 110 | 122 | 130 |
| Consumer Price Index Percent Change | 2.3 | 2.2 | 2.3 | 2.6 |

SOURCE: State of California, Department of Finance, January 9, 1998 (for "Governor's Budget") and May 14, 1997 (for "May Revision").

# ECONOMY AND POPULATION

## Introduction

California's economy, the largest among the 50 states and one of the largest in the world, has major components in high technology, trade, entertainment, agriculture, manufacturing, tourism, construction and services. Since 1994, California's economy has been performing strongly after suffering a deep recession between 1990-94.

## Population and Labor Force

The State's July 1, 1997 population of over 32.9 million represented over 12 percent of the total United States population.

California's population is concentrated in metropolitan areas. As of the April 1, 1990 census, 96 percent resided in the 23 Metropolitan Statistical Areas in the State. As of July 1, 1997, the 5-county Los Angeles area accounted for 49 percent of the State's population, with 16.0 million residents, and the 10-county San Francisco Bay Area represented 21 percent, with a population of 6.9 million.

The following table shows California's population data for 1992 through 1997.

**Population 1992-97**

| Year | California Population[a] | % Increase Over Preceding Year | United States Population[a] | % Increase Over Preceding Year | California as % of United States |
|---|---|---|---|---|---|
| 1992 | 31,188,000 | 2.0 | 255,011,000 | 1.2 | 12.2 |
| 1993 | 31,517,000 | 1.1 | 257,795,000 | 1.1 | 12.2 |
| 1994 | 31,790,000 | 0.9 | 260,372,000 | 1.0 | 12.2 |
| 1995 | 32,063,000 | 0.9 | 262,890,000 | 1.0 | 12.2 |
| 1996 | 32,383,000 | 1.0 | 265,284,000 | 0.9 | 12.2 |
| 1997 | 32,957,000 | 1.8 | 267,575,000 | 0.9 | 12.3 |

[a]Population as of July 1.

SOURCE: U.S. Department of Commerce, Bureau of the Census; State of California, Department of Finance.

The following table presents civilian labor force data for the resident population, age 16 and over, for the years 1992 to 1997.

## Labor Force
## 1992-97

| Year | | Labor Force Trends (Thousands): Labor Force | Labor Force Trends (Thousands): Employment | Unemployment Rate(%): California | Unemployment Rate(%): United States |
|---|---|---|---|---|---|
| 1992 | ....... | 15,404 | 13,973 | 9.3 | 7.5 |
| 1993 | ....... | 15,359 | 13,918 | 9.4 | 6.9 |
| 1994 | ....... | 15,450 | 14,122 | 8.6 | 6.1 |
| 1995 | ....... | 15,428 | 14,217 | 7.8 | 5.6 |
| 1996 | ....... | 15,596 | 14,470 | 7.2 | 5.4 |
| 1997(e) | ....... | 15,879 | 14,870 | 6.4 | 4.9 |

(e) Estimate
SOURCE: State of California, Employment Development Department.

## Employment, Income and Retail Sales

The following table shows California's nonagricultural employment distribution and growth for 1990 and 1997.

### Payroll Employment By Major Sector
### 1990 and 1997

| Industry Sector | Employment (Thousands) 1990 | Employment (Thousands) 1997(e) | % Distribution of Employment 1990 | % Distribution of Employment 1997(e) |
|---|---|---|---|---|
| Mining | 39 | 29 | 0.3 | 0.2 |
| Construction | 605 | 559 | 4.8 | 4.3 |
| Manufacturing | | | | |
| Nondurable goods | 721 | 729 | 5.7 | 5.5 |
| High Technology | 686 | 514 | 5.4 | 3.9 |
| Other Durable goods | 690 | 651 | 5.4 | 5.0 |
| Transportation and Utilities | 624 | 657 | 4.9 | 5.0 |
| Wholesale and Retail Trade | 3,002 | 3,022 | 23.7 | 23.0 |
| Finance, Insurance and Real Estate | 825 | 735 | 6.5 | 5.6 |
| Services | 3,395 | 4,089 | 26.8 | 31.1 |
| Government | | | | |
| Federal | 362 | 290 | 2.9 | 2.2 |
| State and Local | 1,713 | 1,862 | 13.5 | 14.2 |
| TOTAL NONAGRICULTURAL | 12,662 | 13,137 | 100 | 100 |

(e) Estimate
SOURCE: State of California, Employment Development Department and State of California, Department of Finance.

The following tables show California's total and per capita income patterns for selected years.

## Total Personal Income 1992-96

| Year | California Millions | California % Change | California % of U.S. |
|---|---|---|---|
| 1992 ....... | 687,242 | 4.9* | 13.1 |
| 1993 ....... | 702,415 | 2.2 | 12.8 |
| 1994[a] ....... | 722,002 | 2.8 | 12.5 |
| 1995 ....... | 764,435 | 5.9 | 12.5 |
| 1996 ....... | 807,975 | 5.7 | 12.5 |

* Change from prior year.
[a] Reflects Northridge earthquake, which caused an estimated $15 billion drop in personal income.
Note: Omits income for government employees overseas.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

## Per Capita Personal Income 1992-96

| Year | California | % Change | United States | % Change | California % of U.S. |
|---|---|---|---|---|---|
| 1992 ............ | 22,253 | 3.3* | 20,631 | 4.8* | 107.9 |
| 1993 ............ | 22,533 | 1.3 | 21,365 | 3.6 | 105.5 |
| 1994[a] ............ | 23,022 | 2.2 | 22,180 | 3.8 | 103.8 |
| 1995 ............ | 24,217 | 5.2 | 23,348 | 5.3 | 103.7 |
| 1996 ............ | 25,346 | 4.7 | 24,426 | 4.6 | 103.8 |

*Change from prior year
[a] Reflects Northridge earthquake, which caused an estimated $15 billion drop in personal income.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

According to the U.S. Department of Commerce, California accounted for 10.9 percent of all retail trade in the nation in 1996. The following table shows the retail sales of California and of the United States and total taxable sales for California.

**Retail Sales and 1992-96**

| | Total Retail Sales | | | | Taxable Sales | |
|---|---|---|---|---|---|---|
| | California | Percent Change | United States | Percent Change | California | Percent Change |
| 1992 | 231.5 | 0.2* | 1,951.6 | 5.2* | 272.4[(b)] | 0.6 |
| 1993 | 232.4 | 0.4 | 2,072.8 | 6.2 | 272.1 | (0.1) |
| 1994 | 245.8 | 5.8 | 2,227.3 | 7.5 | 286.0 | 5.1 |
| 1995 | 254.2 | 3.4 | 2,324.0 | 4.3 | 301.0 | 5.2 |
| 1996 | 266.3 | 4.8 | 2,445.3 | 5.2 | 321.1 | 6.7 |

*Change from prior year.
[(a)]1991 Taxable Sales includes base expansion. Estimated percent change on a comparable basis is -5.0.
[(b)]1992 Taxable Sales includes base expansion. Estimated percent change on a comparable basis is -0.5.

SOURCE: Retail sales from U.S. Bureau of Census. Taxable sales from the State of California, Board of Equalization. Estimates from State of California, Department of Finance.

## LITIGATION

In addition to litigation discussed in Note 22 to the Audited Financial Statements (see Exhibit 1 to this Appendix A at Page 63), the following information is provided concerning those matters and other matters which either have arisen since the date of the Audited Financial Statements or are not discussed in Note 22.

In the case of *Board of Administration, California Public Employees' Retirement System, et al.* v. *Pete Wilson, Governor, et al.*, plaintiffs challenged the constitutionality of legislation which deferred payment of the State's employer contribution to the Public Employees' Retirement System beginning in Fiscal Year 1992-93. On January 11, 1995, the Sacramento County Superior Court entered a judgment finding that the legislation unconstitutionally impaired the vested contract rights of PERS members. The judgment provides for issuance of a writ of mandate directing State defendants to disregard the provisions of the legislation, to implement the statute governing employer contributions that existed before the changes in the legislation found to be unconstitutional, and to transfer to PERS the contributions that were unpaid to date. On February 19, 1997, the State Court of Appeal affirmed the decision of the Superior Court, and the Supreme Court subsequently refused to hear the case, making the Court of Appeals' ruling final.

On July 30, 1997, the Controller transferred $1.228 billion from the General Fund to PERS in repayment of the principal amount determined to have been improperly deferred. Subsequent State payments to PERS will be made on a quarterly basis. No prejudgment interest has been paid in accordance with the trial court ruling that there was insufficient evidence that money for that purpose had been appropriated and was available. No post-judgment interest was ordered. PERS has filed a claim with the State Board of Control in the amount of $308 million for the accrued interest on the judgment; PERS also seeks interest on the unpaid accrued interest amount. The State Board of Control is expected to rule on this claim in early 1998. See "CURRENT STATE BUDGET – 1997-98 Fiscal Year" and "—Proposed 1998-99 Fiscal Year Budget" above.

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## Appendix A- Exhibit 1

# AUDITED GENERAL PURPOSE FINANCIAL STATEMENTS OF THE STATE OF CALIFORNIA AS OF AND FOR THE YEAR ENDED JUNE 30, 1997

*Prepared under the direction of*
**KATHLEEN CONNELL, State Controller**

## TABLE OF CONTENTS

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# CALIFORNIA STATE AUDITOR


URT R. SJOBERG
ATE AUDITOR

MARIANNE P. EVASHENK
CHIEF DEPUTY STATE AUDITOR


## *Independent Auditors' Report*

THE GOVERNOR AND THE LEGISLATURE OF THE
STATE OF CALIFORNIA

We have audited the general purpose financial statements of the State of California as of and for the year ended June 30, 1997, as listed in the table of contents. These general purpose financial statements are the responsibility of the State's management. Our responsibility is to express an opinion on these general purpose financial statements based on our audit. We did not audit the financial statements of the pension trust funds, which reflect total assets constituting 86 percent of the fiduciary funds. We also did not audit the financial statements of certain enterprise funds, which reflect total assets and revenues, constituting 89 percent and 90 percent, respectively, of the enterprise funds. In addition, we did not audit the University of California funds. Finally, we did not audit the financial statements of certain component unit authorities, which reflect total assets and revenues, constituting 97 percent and 93 percent, respectively, of the component unit authorities. The financial statements of the pension trust funds, certain enterprise funds, the University of California funds, and certain component unit authorities referred to above were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for these funds and entities is based solely upon the reports of the other auditors.

We conducted our audit in accordance with government auditing standards issued by the Comptroller General of the United States and generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based upon our audit and the reports of other auditors, the general purpose financial statements as listed in the table of contents present fairly, in all material respects, the financial position of the State of California as of June 30, 1997, and the results of its operations and the cash flows of its proprietary funds and component unit authorities for the year then ended, in conformity with generally accepted accounting principles.


BUREAU OF STATE AUDITS
660 J Street, Suite 300, Sacramento, California 95814 Telephone: (916) 445-0255 Fax: (916) 327-0019

Our audit was conducted for the purpose of forming an opinion on the general purpose financial statements taken as a whole. The required supplementary information and the combining financial statements and schedules listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the general purpose financial statements of the State of California. Such information has been subjected to the auditing procedures applied in the audit of the general purpose financial statements and, in our opinion, based upon our audit and the reports of other auditors, is fairly presented in all material respects in relation to the general purpose financial statements taken as a whole.

We did not audit the data included in the introductory and statistical sections of this report, and accordingly, we express no opinion on them. In accordance with government auditing standards, reports on the State's internal control structure and on its compliance with laws and regulations will be issued in our single audit report.

BUREAU OF STATE AUDITS

Philip Jelicich

PHILIP J. JELICICH, CPA
Deputy State Auditor

November 21, 1997

STATE OF CALIFORNIA

# GENERAL PURPOSE FINANCIAL STATEMENTS

For the Year Ended
June 30, 1997

*Prepared by the Office of the State Controller*

KATHLEEN CONNELL
State Controller

# Combined Balance Sheet
## All Fund Types, Account Groups, and Discretely Presented Component Units

**June 30, 1997**
(Amounts in thousands)

| | Governmental Fund Types | | | Proprietary Fund Types | |
|---|---|---|---|---|---|
| | General | Special Revenue | Capital Projects | Enterprise | Internal Service |
| **ASSETS** | | | | | |
| Cash and pooled investments (Note 3) | $ 163,092 | $ 4,254,631 | $ 245,585 | $ 2,830,585 | $ 203,187 |
| Investments (Note 3) | — | — | 2,897 | 3,715,285 | — |
| Amount on deposit with U.S. Treasury | — | — | — | — | — |
| Receivables (net) | 155,963 | 335,222 | 1,149 | 98,996 | 1,949 |
| Due from other funds (Note 4) | 4,544,474 | 2,930,126 | 40,888 | 260,513 | 265,218 |
| Due from primary government | — | — | — | — | — |
| Due from other governments | 365,379 | 5,118,031 | 21 | 58,416 | 2,725 |
| Prepaid items | — | — | — | 22,723 | 16,050 |
| Food stamps (Note 1D) | — | 506,956 | — | — | — |
| Inventories, at cost | — | — | — | 20,614 | 64,440 |
| Net investment in direct financing leases (Note 6) | — | — | — | 4,269,352 | — |
| Advances and loans receivable | 670,060 | 1,325,726 | — | 2,768,321 | — |
| Deferred charges | — | — | — | 1,118,511 | — |
| Fixed assets (Note 7) | — | — | — | 5,431,398 | 247,206 |
| Other assets | 1,552 | 23,781 | 147 | 52,653 | 5,669 |
| Amount to be provided for retirement of long-term obligations | — | — | — | — | — |
| **Total Assets** | **$ 5,900,520** | **$ 14,494,473** | **$ 290,687** | **$ 20,647,367** | **$ 806,444** |



*The notes to the financial statements are an integral part of this statement.*

| Fiduciary Fund Type | | | | Component Units | | |
|---|---|---|---|---|---|---|
| Trust and Agency | General Fixed Assets | General Long-Term Obligations | Total Primary Government (Memorandum Only) | University of California | Special Purpose Authorities | Total Reporting Entity (Memorandum Only) |
| $ 17,358,948 | $ — | $ — | $ 25,056,028 | $ 77,547 | $ 765,859 | $ 25,899,434 |
| 222,177,295 | — | — | 225,895,477 | 46,565,585 | 6,914,554 | 279,375,616 |
| 3,667,095 | — | — | 3,667,095 | — | — | 3,667,095 |
| 10,192,878 | — | | 10,786,157 | 1,532,614 | 218,268 | 12,537,039 |
| 7,983,173 | — | — | 16,024,392 | 152,378 | 549 | 16,177,319 |
| — | — | — | — | 127,880 | 3,454 | 131,334 |
| 892,216 | — | — | 6,436,788 | 127,808 | — | 6,564,596 |
| 9,270 | — | — | 48,043 | — | 229 | 48,272 |
| — | — | — | 506,956 | — | — | 506,956 |
| — | — | — | 85,054 | 97,097 | — | 182,151 |
| — | — | — | 4,269,352 | — | — | 4,269,352 |
| 1,583,611 | — | — | 6,347,718 | — | 4,360,172 | 10,707,890 |
| — | — | — | 1,118,511 | 37,777 | 42,579 | 1,198,867 |
| — | 15,955,293 | — | 21,633,897 | 14,306,614 | 574,226 | 36,514,737 |
| 83,204 | — | — | 167,006 | 1,241 | 766,415 | 934,662 |
| — | — | 21,366,388 | 21,366,388 | — | — | 21,366,388 |
| $ 263,947,690 | $ 15,955,293 | $ 21,366,388 | $ 343,408,862 | $ 63,026,541 | $ 13,646,305 | $ 420,081,708 |

(Continued)

*The notes to the financial statements are an integral part of this statement.*

# Combined Balance Sheet

## All Fund Types, Account Groups, and Discretely Presented Component Units

**June 30, 1997**
(Amounts in thousands)

| | Governmental Fund Types | | | Proprietary Fund Types | |
|---|---|---|---|---|---|
| | General | Special Revenue | Capital Projects | Enterprise | Internal Service |
| **LIABILITIES** | | | | | |
| Accounts payable | $ 937,487 | $ 1,167,345 | $ 31,967 | $ 183,302 | $ 96,230 |
| Due to other funds (Note 4) | 4,530,496 | 4,399,187 | 34,867 | 337,775 | 109,273 |
| Due to component units (Note 4) | 163,040 | 154,561 | — | 2,579 | 20,112 |
| Due to other governments | 2,035,709 | 1,904,701 | 3,515 | 121,654 | 573 |
| Dividends payable | — | — | — | — | — |
| Deferred revenue (Note 1D) | — | 506,956 | — | — | — |
| Advances from other funds | 544,371 | 61,428 | — | 122,964 | 94,591 |
| Tax overpayments | — | 6,259 | — | — | — |
| Benefits payable | — | — | — | 69,985 | — |
| Deposits | 5 | 15,392 | — | 6,332 | 1,400 |
| Contracts and notes payable | — | — | — | 947 | 44,963 |
| Lottery prizes and annuities | — | — | — | 2,758,046 | — |
| Compensated absences payable (Note 9) | 114,791 | — | — | 25,807 | 36,655 |
| Certificates of participation, commercial paper, and other borrowings (Notes 10, 11) | — | — | — | 59,810 | — |
| Capital lease obligations (Note 12) | — | — | — | — | 30,262 |
| Advance collections | 18,279 | 299,362 | 1,581 | 330,287 | 122,677 |
| General obligation bonds payable (Note 14) | — | — | — | 3,745,595 | — |
| Revenue bonds payable (Note 15) | — | — | — | 8,547,038 | — |
| Interest payable | 2,532 | — | 20,909 | 180,954 | — |
| Securities lending obligation | — | — | — | — | — |
| Other liabilities | 30,701 | 106,526 | — | 12,354 | 3,218 |
| **Total Liabilities** | 8,377,411 | 8,621,717 | 92,839 | 16,505,429 | 559,954 |
| **FUND EQUITY AND OTHER CREDITS** | | | | | |
| Contributed capital (Notes 1K, 17B) | — | — | — | 216,247 | 112,326 |
| Investment in general fixed assets (Notes 1K, 7) | — | — | — | — | — |
| Retained earnings | | | | | |
| Reserved for regulatory requirements (Note 1K) | — | — | — | 266,271 | — |
| Unreserved (Note 1K) | — | — | — | 3,659,420 | 134,164 |
| **Total Retained Earnings** | — | — | — | 3,925,691 | 134,164 |
| Fund balances | | | | | |
| Reserved for | | | | | |
| Encumbrances (Note 1K) | 442,479 | 2,046,373 | 177,018 | — | — |
| Advances and loans (Note 1K) | 670,060 | 1,325,726 | — | — | — |
| Employees' pension benefits (Note 1K) | — | — | — | — | — |
| Continuing appropriations (Note 1K) | 68,081 | 2,300,139 | 37,965 | — | — |
| Other specific purposes (Notes 1K) | — | — | — | — | — |
| **Total Reserved** | 1,180,620 | 5,672,238 | 214,983 | — | — |
| Unreserved | | | | | |
| **Undesignated (Deficit) (Note 1K)** | (3,657,511) | 200,518 | (17,135) | — | — |
| **Total Fund Equity and Other Credits (Deficit) (Notes 1K, 17)** | (2,476,891) | 5,872,756 | 197,848 | 4,141,938 | 246,490 |
| **Total Liabilities, Fund Equity, and Other Credits** | $ 5,900,520 | $14,494,473 | $ 290,687 | $20,647,367 | $ 80[illegible] |



*The notes to the financial statements are an integral part of this statement.*

| Fiduciary Fund Type | | | Total | Component Units | | Total |
|---|---|---|---|---|---|---|
| Trust and Agency | General Fixed Assets | General Long-Term Obligations | Primary Government (Memorandum Only) | University of California | Special Purpose Authorities | Reporting Entity (Memorandum Only) |
| $ 6,628,284 | $ — | $ — | $ 9,044,615 | $ 1,375,840 | $ 22,461 | $ 10,442,916 |
| 6,613,343 | — | — | 16,024,941 | 152,378 | — | 16,177,319 |
| 2,431 | — | — | 342,723 | — | — | 342,723 |
| 14,200,250 | — | — | 18,266,402 | — | 8,408 | 18,274,810 |
| — | — | — | — | — | 49,700 | 49,700 |
| — | — | — | 506,956 | — | — | 506,956 |
| 534,071 | — | — | 1,357,425 | — | — | 1,357,425 |
| 1,558,710 | — | — | 1,564,969 | — | — | 1,564,969 |
| 908,027 | — | — | 978,012 | — | 4,521,682 | 5,499,694 |
| 4,002,414 | — | — | 4,025,543 | 631,737 | 88,421 | 4,745,701 |
| — | — | — | 45,910 | — | 3,928 | 49,838 |
| — | — | — | 2,758,046 | — | — | 2,758,046 |
| — | — | 1,066,491 | 1,243,744 | 286,548 | 25,759 | 1,556,051 |
| — | — | 903,750 | 963,560 | 1,145,211 | — | 2,108,771 |
| — | — | 2,964,285 | 2,994,547 | 1,229,333 | — | 4,223,880 |
| 47,910 | — | — | 820,096 | — | 211,370 | 1,031,466 |
| — | — | 14,208,431 | 17,954,026 | — | — | 17,954,026 |
| — | — | 569,525 | 9,116,563 | 2,187,675 | 5,168,007 | 16,472,245 |
| — | — | — | 204,395 | — | 131,801 | 336,196 |
| 25,122,038 | — | — | 25,122,038 | 5,443,624 | — | 30,565,662 |
| 1,534,098 | — | 1,653,906 | 3,340,803 | — | 826,835 | 4,167,638 |
| 61,151,576 | — | 21,366,388 | 116,675,314 | 12,452,346 | 11,058,372 | 140,186,032 |
| — | — | — | 328,573 | — | 99 | 328,672 |
| — | 15,955,293 | — | 15,955,293 | 10,239,924 | — | 26,195,217 |
| — | — | — | 266,271 | — | 564,546 | 830,817 |
| — | — | — | 3,793,584 | — | 2,023,288 | 5,816,872 |
| — | — | — | 4,059,855 | — | 2,587,834 | 6,647,689 |
| — | — | — | 2,665,870 | — | — | 2,665,870 |
| 592,850 | — | — | 2,588,636 | — | — | 2,588,636 |
| 196,071,010 | — | — | 196,071,010 | 33,707,965 | — | 229,778,975 |
| — | — | — | 2,406,185 | — | — | 2,406,185 |
| 6,132,254 | — | — | 6,132,254 | 3,715,854 | — | 9,848,108 |
| 202,796,114 | — | — | 209,863,955 | 37,423,819 | — | 247,287,774 |
| — | — | — | (3,474,128) | 2,910,452 | — | (563,676) |
| 202,796,114 | 15,955,293 | — | 226,733,548 | 50,574,195 | 2,587,933 | 279,895,676 |
| $ 263,947,690 | $ 15,955,293 | $ 21,366,388 | $ 343,408,862 | $ 63,026,541 | $ 13,646,305 | $ 420,081,708 |

(Concluded)

The notes to the financial statements are an integral part of this statement.

# Combined Statement of Revenues, Expenditures, and Changes in Fund Balances

## All Governmental Fund Types and Expendable Trust Funds

**Year Ended June 30, 1997**
(Amounts in thousands)

| | Governmental Fund Types | | | Fiduciary Fund Types | Total Primary Government |
|---|---|---|---|---|---|
| | General | Special Revenue | Capital Projects | Expendable Trust | (Memorandum Only) |
| **REVENUES** | | | | | |
| Taxes | $ 47,824,724 | $ 4,322,587 | $ — | $ 4,696,608 | $ 56,843,919 |
| Intergovernmental | — | 26,397,371 | — | 451,973 | 26,849,344 |
| Licenses and permits | 96,358 | 2,920,849 | — | — | 3,017,207 |
| Natural resources | 90,667 | 2,664 | — | — | 93,331 |
| Insurance premiums | — | — | — | 800,620 | 800,620 |
| Charges for services | 132,465 | 277,323 | — | 11,084 | 420,872 |
| Fees | 422,772 | 1,310,260 | — | 487,378 | 2,220,410 |
| Penalties | 11,730 | 283,998 | — | 23,574 | 319,302 |
| Interest | 280,732 | 211,968 | 12,234 | 360,651 | 865,585 |
| Escheat | — | — | — | 310,649 | 310,649 |
| Other | 130,661 | 211,828 | 4,012 | 478,807 | 825,308 |
| **Total Revenues** | 48,990,109 | 35,938,848 | 16,246 | 7,621,344 | 92,566,547 |
| **EXPENDITURES** | | | | | |
| Current | | | | | |
| General government | 2,390,172 | 2,049,162 | 252 | 1,088,026 | 5,527,612 |
| Education | 23,790,214 | 3,867,688 | 3,178 | 1,299,041 | 28,960,121 |
| Health and welfare | 14,653,577 | 23,502,592 | — | 4,643,162 | 42,799,331 |
| Resources | 550,571 | 1,357,876 | 3,209 | 27,158 | 1,938,814 |
| State and consumer services | 365,829 | 346,055 | 18,099 | 100,088 | 830,071 |
| Business and transportation | 47,492 | 5,762,122 | 19 | 18,291 | 5,827,924 |
| Correctional programs | 3,568,739 | 282,216 | — | — | 3,850,955 |
| Property tax relief | 618,447 | 12,510 | — | — | 630,957 |
| Capital outlay | 96,261 | 253,793 | 319,068 | — | 669,122 |
| Debt service | | | | | |
| Principal retirement | 1,040,181 | 2,500 | 16,475 | — | 1,059,156 |
| Interest and fiscal charges | 1,007,913 | 54,509 | 29,464 | — | 1,091,886 |
| **Total Expenditures** | 48,129,396 | 37,491,023 | 389,764 | 7,175,766 | 93,185,949 |
| **Excess (Deficiency) of Revenues Over (Under) Expenditures** | 860,713 | (1,552,175) | (373,518) | 445,578 | (619,402) |
| **OTHER FINANCING SOURCES (USES)** | | | | | |
| Proceeds from general obligation bonds, commercial paper, and capital leases | 96,261 | 2,264,807 | 260,022 | — | 2,621,090 |
| Proceeds from refunding cert. of participation | 22,198 | — | — | — | 22,198 |
| Proceeds from revenue bonds | — | — | 330,507 | — | 330,507 |
| Operating transfers in | 196,129 | 2,259,854 | 65,683 | 451,704 | 2,973,370 |
| Operating transfers out | (725,782) | (1,901,052) | (6,959) | (302,380) | (2,936,173) |
| Transfers out - component unit | (2,135,432) | (76,260) | (23,422) | — | (2,235,114) |
| Payment to refunding escrow agent | (22,198) | — | — | — | (22,198) |
| Payment to refund commercial paper | — | (727,605) | (105,075) | — | (832,680) |
| **Total Other Financing Sources (Uses)** | (2,568,824) | 1,819,744 | 520,756 | 149,324 | (79,000) |
| **Excess of Revenues and Other Financing Sources Over (Under) Expenditures and Other Financing Uses** | (1,708,111) | 267,569 | 147,238 | 594,902 | (698,402 |
| **Fund Balances (Deficit), July 1, 1996** | (768,780) | 5,605,187 | 50,610 | 6,130,202 * | 11,017,219 |
| **Fund Balances (Deficit), June 30, 1997** | $ (2,476,891) | $ 5,872,756 | $ 197,848 | $ 6,725,104 | $ 10,318,817 |

*Restated (see Note 1L)



*The notes to the financial statements are an integral part of this statement.*

# Combined Statement of Revenues, Expenditures, and Changes in Fund Balances Budgetary Basis - Budget and Actual

## All Governmental Fund Types

**Year Ended June 30, 1997**
(Amounts in thousands)

| | General | | | Special Revenue | | |
|---|---|---|---|---|---|---|
| | Budget (Note 2A) | Actual | Variance Favorable (Unfavorable) | Budget (Note 2A) | Actual | Variance Favorable (Unfavorable) |
| **REVENUES** | | | | | | |
| Taxes | — | $ 47,898,822 | — | — | $ 159,218 | — |
| Intergovernmental | — | — | — | — | 23,640,339 | — |
| Licenses and permits | — | 92,761 | — | — | 2,917,345 | — |
| Natural resources | — | 90,627 | — | — | 65 | — |
| Charges for services | — | 47,665 | — | — | 277,322 | — |
| Fees | — | 417,687 | — | — | 1,296,530 | — |
| Penalties | — | 20,082 | — | — | 284,005 | — |
| Interest | — | 278,573 | — | — | 211,637 | — |
| Other | — | 315,135 | — | — | 1,530,904 | — |
| **Total Revenues** | — | 49,161,352 | — | — | 30,317,365 | — |
| **EXPENDITURES** | | | | | | |
| Current | | | | | | |
| General government | $ 1,776,889 | 1,711,596 | $ 65,293 | $ 2,143,559 | 2,050,927 | $ 92,632 |
| Education | 25,795,334 | 25,768,100 | 27,234 | 4,102,671 | 3,963,245 | 139,426 |
| Health and welfare | 15,222,210 | 14,892,531 | 329,679 | 21,750,107 | 20,511,597 | 1,238,510 |
| Resources | 626,876 | 592,172 | 34,704 | 1,563,236 | 1,416,551 | 146,685 |
| State and consumer services | 371,024 | 367,111 | 3,913 | 386,080 | 346,047 | 40,033 |
| Business and transportation | 57,125 | 56,887 | 238 | 6,087,999 | 5,476,843 | 611,156 |
| Correctional programs | 3,728,964 | 3,588,286 | 140,678 | 286,526 | 282,649 | 3,877 |
| Property tax relief | 629,830 | 613,991 | 15,839 | — | 12,510 | (12,510) |
| Capital outlay | — | — | — | 243,122 | 236,143 | 6,979 |
| Debt service | | | | | | |
| Principal retirement | 1,263,505 | 1,263,505 | — | 109,006 | 109,006 | — |
| Interest and fiscal charges | 806,994 | 784,601 | 22,393 | 850,074 | 849,943 | 131 |
| **Total Expenditures** | $ 50,278,751 | 49,638,780 | $ 639,971 | $ 37,522,380 | 35,255,461 | $ 2,266,919 |
| **OTHER FINANCING SOURCES (USES)** | | | | | | |
| Operating transfers in | — | 230,804 | — | — | 13,579,067 | — |
| Operating transfers out | — | (217,262) | — | — | (9,643,047) | — |
| Bonds authorized | — | — | — | — | 995,000 | — |
| **Net Other Financing Sources (Uses)** | — | 13,542 | — | — | 4,931,020 | — |
| **Excess of Revenues and Other Financing Sources (Under) Expenditures and Other Financing Uses** | — | (463,886) | — | — | (7,076) | — |
| **Fund Balances, July 1, 1996** | — | 1,103,729 * | — | — | 10,078,292 * | — |
| **Fund Balances, June 30, 1997** | — | $ 639,843 | — | — | $ 10,071,216 | — |

* Restated (see Note 2B)

(Continued)

# Combined Statement of Revenues, Expenditures, and Changes in Fund Balances Budgetary Basis - Budget and Actual

## All Governmental Fund Types

**Year Ended June 30, 1997**
(Amounts in thousands)

| | Capital Projects | | |
|---|---|---|---|
| | Budget (Note 2A) | Actual | Variance Favorable (Unfavorable) |
| **REVENUES** | | | |
| Interest | — | $ 9,913 | — |
| Other | — | 29,500 | — |
| **Total Revenues** | — | 39,413 | — |
| **EXPENDITURES** | | | |
| Current | | | |
| Education | $ 3,765 | 3,155 | $ 610 |
| Resources | 4,384 | 3,209 | 1,175 |
| State and consumer services | 9,029 | (8,982) | 18,011 |
| Capital outlay | 266,550 | 206,837 | 59,713 |
| Debt service | | | |
| Principal retirement | 6,050 | 6,050 | — |
| Interest and fiscal charges | 3,844 | 3,844 | — |
| **Total Expenditures** | $ 293,622 | 214,113 | $ 79,509 |
| **OTHER FINANCING SOURCES (USES)** | | | |
| Operating transfers in | — | 110,346 | — |
| Operating transfers out | — | (91,199) | — |
| **Net Other Financing Sources (Uses)** | — | 19,147 | — |
| **Excess of Revenues and Other Financing Sources (Under) Expenditures and Other Financing Uses** | — | (155,553) | — |
| **Fund Balances, July 1, 1996** | — | 1,591,766 * | — |
| **Fund Balances, June 30, 1997** | — | $ 1,436,213 | — |

*Restated (see Note 2B)

(Concluded)



*The notes to the financial statements are an integral part of this statement.*

# Combined Statement of Revenues, Expenses, and Changes in Retained Earnings

## All Proprietary Fund Types and Discretely Presented Component Units – Special Purpose Authorities

**Year Ended June 30, 1997**
(Amounts in thousands)

| | Proprietary Fund Types | | Total Primary Government (Memorandum Only) | Component Units | Total Reporting Entity (Memorandum Only) |
|---|---|---|---|---|---|
| | Enterprise | Internal Service | | Special Purpose Authorities | |
| **OPERATING REVENUES** | | | | | |
| Lottery ticket sales | $ 2,063,135 | $ — | $ 2,063,135 | $ — | $ 2,063,135 |
| Service and sales | 1,058,714 | 1,297,597 | 2,356,311 | 144,760 | 2,501,071 |
| Earned premiums (net) | 429 | — | 429 | 992,197 | 992,626 |
| Investment and interest | 271,167 | — | 271,167 | 308,106 | 579,273 |
| Contributions | — | — | — | 2,439 | 2,439 |
| Rent | 356,090 | — | 356,090 | 19,035 | 375,125 |
| Other | 3,416 | — | 3,416 | 7,277 | 10,693 |
| **Total Operating Revenues** | 3,752,951 | 1,297,597 | 5,050,548 | 1,473,814 | 6,524,362 |
| **OPERATING EXPENSES** | | | | | |
| Lottery prizes | 1,030,536 | — | 1,030,536 | — | 1,030,536 |
| Personal services | 286,949 | 310,274 | 597,223 | 133,515 | 730,738 |
| Supplies | 68,033 | 20,020 | 88,053 | 6 | 88,059 |
| Services and charges | 660,649 | 905,864 | 1,566,513 | 218,062 | 1,784,575 |
| Depreciation | 86,646 | 44,993 | 131,639 | 15,250 | 146,889 |
| Benefit payments | — | — | — | 1,088,349 | 1,088,349 |
| Interest expense | 527,180 | 7,948 | 535,128 | 309,485 | 844,613 |
| Amortization (recovery) of deferred charges | 68,766 | — | 68,766 | 1,707 | 70,473 |
| **Total Operating Expenses** | 2,728,759 | 1,289,099 | 4,017,858 | 1,766,374 | 5,784,232 |
| **Operating Income (Loss)** | 1,024,192 | 8,498 | 1,032,690 | (292,560) | 740,130 |
| **NONOPERATING REVENUES (EXPENSES)** | | | | | |
| Grants received | 389 | — | 389 | 72,832 | 73,221 |
| Grants provided | (34,444) | — | (34,444) | (72,832) | (107,276) |
| Interest revenue | 224,302 | 2,746 | 227,048 | 553,525 | 780,573 |
| Interest expense and fiscal charges | (207,053) | (119) | (207,172) | (2,705) | (209,877) |
| Dividends paid | — | — | — | (117,069) | (117,069) |
| Lottery payments for education | (727,626) | — | (727,626) | — | (727,626) |
| Other | (16,981) | (1,110) | (18,091) | (2,477) | (20,568) |
| **Total Nonoperating Revenues (Expenses)** | (761,413) | 1,517 | (759,896) | 431,274 | (328,622) |
| **Income (Loss) Before Operating Transfers** | 262,779 | 10,015 | 272,794 | 138,714 | 411,508 |
| **OPERATING TRANSFERS** | | | | | |
| Operating transfers in | 603,348 | 8,848 | 612,196 | — | 612,196 |
| Operating transfers out | (649,393) | — | (649,393) | — | (649,393) |
| **Total Operating Transfers** | (46,045) | 8,848 | (37,197) | — | (37,197) |
| **Net Income** | 216,734 | 18,863 | 235,597 | 138,714 | 374,311 |
| **Retained Earnings, July 1, 1996** | 3,708,957 * | 115,301 | 3,824,258 | 2,449,120 | 6,273,378 |
| **Retained Earnings, June 30, 1997** | $ 3,925,691 | $ 134,164 | $ 4,059,855 | $ 2,587,834 | $ 6,647,689 |

*Restated (see Note 1L)

*The notes to the financial statements are an integral part of this statement.*

# Combined Statement of Cash Flows

## All Proprietary Fund Types and Discretely Presented Component Units – Special Purpose Authorities

**Year Ended June 30, 1997**
(Amounts in thousands)

| | Proprietary Fund Types | | Component Units |
|---|---|---|---|
| | Enterprise | Internal Service (1) | Special Purpose Authorities |
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Operating income (loss) | $ 1,024,192 | $ 8,498 | $ (292,560) |
| **ADJUSTMENTS TO RECONCILE OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY OPERATIONS** | | | |
| Interest expense on operating debt | 24,126 | 7,948 | 309,485 |
| Depreciation | 86,646 | 44,993 | 15,250 |
| Accretion of capital appreciation bonds | 10,510 | — | 9,562 |
| Provisions and allowances | (1,796) | — | 921 |
| Accrual of deferred charges | (854) | — | 6 |
| Amortization of deferred credits | (3,460) | — | (3,910) |
| Amortization of discounts | 2,120 | — | 5,512 |
| Amortization (recovery) of deferred charges | 65,103 | — | — |
| Purchase of program loans | (149) | — | (849,199) |
| Collection of principal from program loans | 139,348 | — | 220,725 |
| Other | 2,497 | 162 | 2,705 |
| Change in assets and liabilities | | | |
| Receivables | 648 | 350 | (1,079) |
| Due from other funds | (18,622) | (4,300) | 170 |
| Due from primary government | — | — | 9,866 |
| Due from other governments | 7,932 | 14,297 | — |
| Prepaid items | 3,303 | (2,670) | 15 |
| Inventories | 1,857 | 15,227 | — |
| Net investment in direct financing leases | (94,722) | — | — |
| Advances and loans receivable | (1,336) | — | — |
| Other assets | 6,865 | 454 | 5,719 |
| Accounts payable | (35,629) | 5,592 | 2,081 |
| Interest payable | (6,265) | — | — |
| Due to other funds | 9,923 | (8,494) | (743) |
| Due to component units | — | 1,228 | — |
| Due to other governments | (7,411) | 522 | — |
| Benefits payable | (13,074) | — | (98,120) |
| Deposits | (106) | (396) | 3,479 |
| Lottery prizes and annuities | 66,791 | — | — |
| Contract and notes payable | 294 | — | — |
| Compensated absences payable | (6,641) | (38) | 1,200 |
| Capital lease obligation | (313) | — | — |
| Advance collections | 8,547 | (21,546) | (15,017) |
| Other liabilities | (2,397) | (1,772) | 509 |
| **Total Adjustments** | **243,735** | **51,557** | **(380,863)** |
| **Net Cash Provided by (Used In) Operating Activities** | **1,267,927** | **60,055** | **(673,423)** |

(Continued)

(1) Internal service funds made *non-cash transactions* for installment purchases totaling $9 million to acquire equipment. Noncash transactions are those portions of investing and financing activ that affected assets and liabilities but did not result in cash receipts or payments during the per.



*The notes to the financial statements are an integral part of this statement.*

| | Proprietary Fund Types | | Component Units |
|---|---|---|---|
| | Enterprise | Internal Service (1) | Special Purpose Authorities |
| **CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES** | | | |
| Dividends paid | — | — | (127,369) |
| Advances from other funds | — | — | 938 |
| Return of advances from other funds | (52,000) | | — |
| Proceeds from revenue bonds | — | — | 1,101,467 |
| Retirement of general obligation bonds | (200,045) | — | — |
| Retirement of revenue bonds | (47,395) | — | (361,187) |
| Interest paid on operating debt | (653) | — | (293,719) |
| Operating transfers in | 60,339 | 8,848 | 2,380 |
| Operating transfers out | (159,736) | — | — |
| Grants provided | (34,444) | — | (72,832) |
| Lottery payments for education | (767,488) | — | — |
| **Net Cash Provided by (Used In) Non-capital Financing Activities** | **(1,201,422)** | **8,848** | **249,678** |
| **CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES** | | | |
| Unamortized water project costs | (17,528) | — | — |
| Acquisition of intangible assets | — | (1,905) | — |
| Acquisition of fixed assets | (639,049) | (43,981) | (58,026) |
| Proceeds from sale of fixed assets | 850 | 15,331 | 792 |
| Advances from other funds | 368,404 | — | — |
| Return of advances from other funds | (393,573) | (296) | — |
| Proceeds from notes payable and commercial paper | 149,000 | — | — |
| Principal paid on notes payable and commercial paper | (110,190) | (24,329) | (44,925) |
| Payment of capital lease obligations | — | (2,072) | — |
| Retirement of general obligation bonds | (36,645) | — | — |
| Proceeds from revenue bonds | 1,379,331 | — | 77,804 |
| Retirement of revenue bonds | (1,247,282) | — | — |
| Interest paid | (211,601) | (8,067) | (1,474) |
| Contributed capital | — | 403 | 99 |
| Grants received | 389 | — | 72,832 |
| Operating transfers in | 54,041 | — | — |
| **Net Cash Provided by (Used In) Capital and Related Financing Activities** | **(703,853)** | **(64,916)** | **47,102** |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Purchase of investments | (333,433) | — | (340,768) |
| Advances and loans provided | (85,692) | — | (3,527) |
| Collection of advances and loans | 38,929 | 15,400 | — |
| Proceeds from maturity and sale of investments | 491,274 | — | 318,266 |
| Interest on investments | 208,496 | 2,375 | 554,417 |
| **Net Cash Provided by Investing Activities** | **319,574** | **17,775** | **528,388** |
| **Net Increase (Decrease) in Cash and Pooled Investments** | **(317,774)** | **21,762** | **151,745** |
| **Cash and Pooled Investments at July 1, 1996** | **3,148,359** | **181,425** | **614,114** |
| **Cash and Pooled Investments at June 30, 1997** | **$ 2,830,585** | **$ 203,187** | **$ 765,859** |

(Concluded)

*The notes to the financial statements are an integral part of this statement.*

# Combined Statement of Changes in Plan Net Assets

## Pension Trust Funds and Discretely Presented Component Unit – University of California

**Year Ended June 30, 1997**
(Amounts in thousands)

| | Primary Government<br>Pension Trust Funds | Component Unit<br>University of California<br>Retirement System Funds |
|---|---|---|
| **ADDITIONS** | | |
| Contributions | | |
| Employer | $ 4,170,325 | $ 358 |
| Plan member | 2,589,005 | 346,197 |
| **Total Contributions** | **6,759,330** | **346,555** |
| Investment income | | |
| Net appreciation in fair value of investments | 24,170,031 | 5,578,814 |
| Interest, dividends, and other investment income | 9,277,450 | 1,280,463 |
| Less: Investment expense | (1,953,417) | (200,738) |
| **Net Investment Income** | **31,494,064** | **6,658,539** |
| Other | 2,613 | 63,169 |
| **Total Additions** | **38,256,007** | **7,068,263** |
| **DEDUCTIONS** | | |
| Benefits | 7,090,095 | 850,334 |
| Refunds of contributions | 220,714 | — |
| Administrative expense | 146,405 | 18,497 |
| **Total Deductions** | **7,457,214** | **868,831** |
| **Net Increase in Fund Balance Reserved for Employees' Pension Benefits** | **30,798,793** | **6,199,432** |
| **Fund Balance Reserved for Employees' Pension Benefits, July 1, 1996** | **165,272,217** | **27,508,533 *** |
| **Fund Balance Reserved for Employees' Pension Benefits, June 30, 1997** | **$ 196,071,010** | **$ 33,707,965** |

*Restated (see Note 1L)



*The notes to the financial statements are an integral part of this statement.*

# Combined Balance Sheet – Discretely Presented Component Unit – University of California

**June 30, 1997**
(Amounts in thousands)

| | Current Funds | Loan Funds | Endowment and Similar Funds | Plant Funds | Retirement System Funds | Total (Memorandum Only) |
|---|---|---|---|---|---|---|
| **ASSETS** | | | | | | |
| Cash | $ 75,107 | $ — | $ — | $ 2,440 | $ — | $ 77,547 |
| Investments | 3,904,867 | 62,456 | 3,822,418 | 1,379,543 | 37,396,301 | 46,565,585 |
| Receivables (net) | 911,780 | 261,233 | 9,752 | 14,113 | 335,736 | 1,532,614 |
| Due from other funds | 9,409 | — | 16,763 | 1,533 | 124,673 | 152,378 |
| Due from primary government | 127,880 | — | — | — | — | 127,880 |
| Due from other governments | 126,423 | 1,385 | — | — | — | 127,808 |
| Inventories, at cost | 97,097 | — | — | — | — | 97,097 |
| Deferred charges | 37,777 | — | — | — | — | 37,777 |
| Fixed assets | — | — | — | 14,306,614 | — | 14,306,614 |
| Other assets | — | — | — | 1,241 | — | 1,241 |
| **Total Assets** | **$ 5,290,340** | **$ 325,074** | **$ 3,848,933** | **$ 15,705,484** | **$ 37,856,710** | **$ 63,026,541** |
| **LIABILITIES AND FUND EQUITY** | | | | | | |
| **Liabilities** | | | | | | |
| Accounts payable | $ 1,301,566 | $ — | $ 3,130 | $ 43,344 | $ 27,800 | $ 1,375,840 |
| Due to other funds | 124,673 | 2,000 | 9,284 | 16,421 | — | 152,378 |
| Deposits | 246,922 | — | 384,815 | — | — | 631,737 |
| Compensated absences | 286,548 | — | — | — | — | 286,548 |
| Commercial paper and other borrowings | 61,680 | — | — | 1,083,531 | — | 1,145,211 |
| Capital lease obligations | — | — | — | 1,229,333 | — | 1,229,333 |
| Revenue bonds payable | — | 12,845 | — | 2,174,830 | — | 2,187,675 |
| Securities lending obligation | 806,744 | 13,460 | 282,287 | 220,188 | 4,120,945 | 5,443,624 |
| **Total Liabilities** | **2,828,133** | **28,305** | **679,516** | **4,767,647** | **4,148,745** | **12,452,346** |
| **Fund Equity** | | | | | | |
| Investment in general fixed assets | — | — | — | 10,239,924 | — | 10,239,924 |
| Fund balances | | | | | | |
| Employees' pension benefits | — | — | — | — | 33,707,965 | 33,707,965 |
| Reserved for other specific purposes | 667,017 | 267,926 | 2,435,620 | 345,291 | — | 3,715,854 |
| Undesignated | 1,795,190 | 28,843 | 733,797 | 352,622 | — | 2,910,452 |
| **Total Fund Equity** | **2,462,207** | **296,769** | **3,169,417** | **10,937,837** | **33,707,965** | **50,574,195** |
| **Total Liabilities and Fund Equity** | **$ 5,290,340** | **$ 325,074** | **$ 3,848,933** | **$ 15,705,484** | **$ 37,856,710** | **$ 63,026,541** |

*The notes to the financial statements are an integral part of this statement.*

# Combined Statement of Changes in Fund Balances – Discretely Presented Component Unit – University of California

**Year Ended June 30, 1997**
(Amounts in thousands)

| | Current Funds | Loan Funds | Endowment and Similar Funds | Plant Funds |
|---|---|---|---|---|
| **REVENUES AND OTHER ADDITIONS** | | | | |
| Student tuition and fees | $ 1,009,443 | $ — | $ — | $ 14,657 |
| U.S. Government | 3,945,070 | 2,126 | — | 20,877 |
| Local Government | 92,502 | — | — | — |
| Sales and services | | | | |
| Educational activities | 707,396 | — | — | — |
| Medical centers | 2,130,508 | — | — | — |
| Auxiliary enterprises | 570,280 | — | — | — |
| Private gifts, grants, and contracts | 581,946 | 262 | 27,129 | 84,788 |
| Investment income | | | | |
| Endowment activities | 106,435 | — | 788 | — |
| Securities lending | 66,205 | 706 | — | 5,958 |
| Other | 162,531 | 8,269 | — | 48,817 |
| Net appreciation (depreciation) in fair value of investments | (26,837) | (501) | 527,506 | (5,879) |
| Expended for plant facilities | — | — | — | 603,438 |
| Retirement of indebtedness | — | — | — | 159,986 |
| Other revenues | 243,989 | — | — | — |
| Transfers in - primary government | 2,200,513 | — | — | 34,601 |
| Other additions | 60,892 | 2,910 | 1,281 | 1,600 |
| **Total Revenues and Other Additions** | 11,850,873 | 13,772 | 556,704 | 968,843 |
| **EXPENDITURES AND OTHER DEDUCTIONS** | | | | |
| Current fund expenditures | | | | |
| Educational and general | 5,952,995 | — | — | — |
| Medical centers | 1,958,461 | — | — | — |
| Auxiliary enterprises | 475,053 | — | — | — |
| Department of Energy Laboratories | 2,537,056 | — | — | — |
| Securities lending fees and rebates | 63,998 | 682 | — | 5,759 |
| Plant fund expenditures | — | — | — | 173,218 |
| Debt service | | | | |
| Principal retirement | — | — | — | 159,986 |
| Interest | — | — | — | 209,330 |
| Disposal of plant assets | — | — | — | 237,946 |
| Debt extinguishment | — | — | — | 13,670 |
| Other | 50,259 | 5,956 | 21,451 | 4,039 |
| **Total Expenditures and Other Deductions** | 11,037,822 | 6,638 | 21,451 | 803,948 |
| **TRANSFERS AMONG FUNDS** | | | | |
| Mandatory contractual arrangements | | | | |
| Loan funds matching grants | (1,106) | 1,106 | — | — |
| Principal and interest | (268,129) | — | — | 268,129 |
| Nonmandatory (discretionary allocations) | (94,902) | 11 | 27,239 | 67,652 |
| **Total Transfers Among Funds** | (364,137) | 1,117 | 27,239 | 335,781 |
| **Net Increase in Fund Balances** | 448,914 | 8,251 | 562,492 | 500,676 |
| **Fund Balances, July 1, 1996** | 2,013,293 * | 288,518 * | 2,606,925 * | 10,437,161 * |
| **Fund Balances, June 30, 1997** | $ 2,462,207 | $ 296,769 | $ 3,169,417 | $ 10,937,837 |

* Restated (see Note 1L)



*The notes to the financial statements are an integral part of this statement.*

# Combined Statement of Current Funds Revenues, Expenditures, and Other Changes – Discretely Presented Component Unit – University of California

**Year Ended June 30, 1997**
(Amounts in thousands)

| | Current Funds Unrestricted | Current Funds Restricted | Total (Memorandum Only) |
|---|---|---|---|
| **REVENUES** | | | |
| Student tuition and fees | $ 1,009,443 | $ — | $ 1,009,443 |
| U.S. Government appropriations, grants and contracts | 266,250 | 1,105,744 | 1,371,994 |
| Local government grants and contracts | 1,367 | 101,018 | 102,385 |
| Sales and services | | | |
| Education activities | 707,396 | — | 707,396 |
| Medical centers | 2,130,508 | — | 2,130,508 |
| Auxiliary enterprises | 570,280 | — | 570,280 |
| Private gifts, grants and contracts | 54,187 | 460,786 | 514,973 |
| Investment income | | | |
| Endowment and similar funds | 24,226 | 64,348 | 88,574 |
| Securities lending | 43,662 | 21,791 | 65,453 |
| Other | 131,024 | — | 131,024 |
| Net appreciation (depreciation) in fair value of investments | (23,480) | — | (23,480) |
| Department of Energy Laboratories | 29,167 | 2,537,056 | 2,566,223 |
| Other revenues | 243,989 | — | 243,989 |
| Transfers in - primary government | 1,884,515 | 225,154 | 2,109,669 |
| **Total Revenues** | 7,072,534 | 4,515,897 | 11,588,431 |
| **EXPENDITURES AND MANDATORY TRANSFERS** | | | |
| Educational and general | | | |
| Instructional | 1,810,391 | 120,845 | 1,931,236 |
| Research | 262,193 | 1,324,340 | 1,586,533 |
| Public service | 98,068 | 108,761 | 206,829 |
| Academic support | 715,377 | 103,917 | 819,294 |
| Student services | 248,600 | 9,289 | 257,889 |
| Institutional support | 420,879 | 21,354 | 442,233 |
| Operation and maintenance of plant | 285,386 | 1,447 | 286,833 |
| Student financial aid | 165,005 | 257,143 | 422,148 |
| **Total Educational and General** | 4,005,899 | 1,947,096 | 5,952,995 |
| Mandatory transfers | | | |
| Loan fund matching grant | 467 | 639 | 1,106 |
| Debt service | 85,052 | 93,500 | 178,552 |
| **Total Mandatory Transfers** | 85,519 | 94,139 | 179,658 |
| Medical Centers | | | |
| Expenditures | 1,955,583 | 2,878 | 1,958,461 |
| Mandatory transfers | 18,803 | — | 18,803 |
| **Total Medical centers** | 1,974,386 | 2,878 | 1,977,264 |
| Auxiliary enterprises | | | |
| Expenditures | 467,977 | 7,076 | 475,053 |
| Mandatory transfers | 70,774 | — | 70,774 |
| **Total Auxiliary Enterprises** | 538,751 | 7,076 | 545,827 |
| Department of Energy Laboratories | — | 2,537,056 | 2,537,056 |
| Securities lending fees and rebates | 42,207 | 21,791 | 63,998 |
| **Total Expenditures and Mandatory Transfers** | 6,646,762 | 4,610,036 | 11,256,798 |
| **OTHER TRANSFERS AND ADDITIONS (DEDUCTIONS)** | | | |
| Restricted receipts in excess of restricted expenditures | — | 201,550 | 201,550 |
| Nonmandatory transfers | (47,361) | (47,541) | (94,902) |
| Other | 7,504 | 3,129 | 10,633 |
| **Total Other Transfers and Additions (Deductions)** | (39,857) | 157,138 | 117,281 |
| **Net Increase in Fund Balances** | $ 385,915 | $ 62,999 | $ 448,914 |

*The notes to the financial statements are an integral part of this statement.*

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# Notes to the Financial Statements

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements present information on the financial activities of the State of California over which the Governor, the Legislature, and other elected officials have direct or indirect governing and fiscal control. These financial statements have been prepared in conformity with generally accepted accounting principles (GAAP). The provisions of Governmental Accounting Standards Board (GASB) Statement No. 27, Accounting for Pensions by State and Local Government Employers, GASB Statement No. 28, Accounting and Financial Reporting for Securities Lending Transactions, and GASB Statement No. 30, Risk Financing Omnibus - an amendment of GASB Statement No. 10 have been implemented in this report. The University of California, a discretely presented component unit, has also implemented GASB Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools, even though the implementation is not required until next year.

### A. Reporting Entity

As required by GAAP, these financial statements present the primary government of the State and its component units. The **primary government** consists of all funds, account groups, organizations, institutions, agencies, departments, and offices that are not legally separate from the State. Component units are organizations which are legally separate from the State but for which the State is financially accountable, or for which the nature and significance of their relationship with the State is such that exclusion would cause the State's financial statements to be misleading or incomplete. The decision to include a potential component unit in the State's reporting entity is based on several criteria including legal standing, fiscal dependency, and financial accountability. Following is information on blended and discretely presented component units for the State.

**Blended component units**, although legally separate entities, are in substance part of the primary government's operations. Therefore, data from these blended component units are blended into the appropriate funds for reporting purposes.

Building authorities are blended component units because they have been created through the use of Joint Exercise of Powers Agreements with various cities to finance the construction of state buildings. The building authorities are reported as capital projects funds. As a result, the capital lease arrangements between the building authorities and the State of $312 million have been eliminated from the combined balance sheet. Instead, only th underlying fixed assets and the debt used to acquire them a reported in the appropriate account groups. Copies of the financial statements of the building authorities may be obtained from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5876.

**Discretely presented component units** are reported in separate columns in the combined financial statements. Discretely presented component units are legally separate from the primary government, and mostly provide services to entities and individuals outside the State. For ease of presentation, discretely presented component units, other than the University of California, are included in the statements under the heading of special purpose authorities.

The University of California was founded in 1868 as a public, state-supported, land grant institution. It was written into the State Constitution of 1879 as a public trust to be administered by a governing board, the Regents of the University of California. The University of California is a component unit of the State because the State appoints a voting majority of the Regents of the University of California, and expenditures for the support of various University of California programs and capital outlay are appropriated by the annual Budget Act. Copies of the University of California's separately issued financial statements may be obtained from the University of California, Business and Finance, 21st Floor, 300 Lakeside Drive, Oakland, California 94612-3550.

Special purpose authorities are presented in three separate categories for condensed financial statement reporting purposes: State Compensation Insurance Fund (SCIF), California Housing Finance Agency (CHFA), and Non-Major Component Units. SCIF and CHFA are considered major component units while all other component units are shown as Non-Major Component Units.

The SCIF is a self-supporting enterprise created to offer insurance protection to employers at the lowest possible cost. It operates in competition with other insurance carriers to provide services to the State, counties, cities, school districts, or other public corporations. It is a component unit of the State because the State appoints all five voting members of the SCIF's governing board and has the authority to approve or modify the SCIF's budget. Copies of the SCIF's financial statements for the year ended December 31, 1996, may be obtained from the State Compensation Insurance Fund, 1275 Market Street, San Francisco, California 94103.

The CHFA was created by the Zenovich-Moscone Chacon Housing and Home Finance Act, as amended. The CHFA's purpose is to meet the housing needs of persons and families of low and moderate income. It is a component unit of the State because the St appoints a voting majority of the CHFA's governing board and h the authority to approve or modify its budget. Copies of the CHFA's financial statements may be obtained from the California Housing Finance Agency, 1121 L Street, Sacramento, California 95814.

State legislation created various other Non-Major Component Units to provide certain services outside the primary government and to provide certain private and public entities with a low-cost source of financing for programs deemed to be in the public interest. These entities are considered component units because the majority of governing board members are appointed by, or are members of, the primary government. Copies of the financial statements of these component units may be obtained from the Office of the State Controller, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250–5876. The Non-Major Component Units are:

The California Alternative Energy and Advanced Transportation Financing Authority, which provides financing for the alternative energy and advanced transportation technologies;

The California Pollution Control Financing Authority, which provides financing for pollution control facilities;

The California Health Facilities Financing Authority, which provides financing for the construction, equipping, or acquiring of health facilities;

The California Educational Facilities Authority, which issues revenue bonds to assist private educational institutions of higher learning in the expansion and construction of educational facilities;

The California School Finance Authority, which provides loans to school and community college districts to assist in obtaining equipment and facilities;

The California Economic Development Financing Authority, which issues revenue and general obligation bonds to finance business development and public infrastructure projects;

The District Agricultural Associations, which exhibit all of the industries, industrial enterprises, resources, and products of the State; and

The San Joaquin River Conservancy, which was created to acquire and manage public lands within the San Joaquin River Parkway.

**A joint venture** is an entity, resulting from a contractual arrangement, that is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control. In such an arrangement, the participants retain an ongoing financial interest or an ongoing financial responsibility in the entity. These entities are not part of the primary government or a component unit.

The State participates in only one joint venture with the Capitol Area Development Authority (CADA). The CADA was created in 19 by the Joint Exercise of Powers Agreement between the primary government and the City of Sacramento for the location of state buildings and other improvements. The CADA is a public entity separate from the primary government and the City, and is administered by a board of five members: two appointed by the primary government, two appointed by the City, and one appointed by the affirmative vote of at least three of the other four members of the board. The primary government designates the chairperson of the board. Although the primary government does not have an equity interest in the CADA, it does have an ongoing financial interest. Based upon the appointment authority, the primary government has the ability to indirectly influence the CADA to undertake special projects for the citizenry of the participants. The primary government subsidizes the CADA's operations by leasing land to the CADA without consideration; however, the primary government is not obligated to do so. Since the primary government does not have an equity interest in the CADA, the CADA's financial information is not included in the financial statements of this report. Separately issued financial statements can be obtained from the Capitol Area Development Authority, 1530 Capitol Avenue, Sacramento, California 95814.

## B. Fund Accounting

The financial statements of the State are organized and operated on the basis of funds, account groups, and component units. A fund is an independent fiscal and accounting entity with a self-balancing set of accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with finance-related legal and contractual provisions. The minimum number of funds are maintained consistent with legal and managerial requirements. Account groups are a reporting device to account for certain assets and liabilities of the governmental funds that are not recorded directly in those funds. A component unit is an organization which is legally separate from the State but for which the State is financially accountable or for which the nature and significance of their relationship with the State is such that exclusion would cause the State's financial statements to be misleading or incomplete.

The financial activities of the State accounted for in the accompanying financial statements are classified as follows.

**Governmental Fund Types** are used primarily to account for services provided to the general public without charging directly for those services. The State has three governmental fund types.

The *General Fund* is the main operating fund of the State. It accounts for transactions related to resources obtained and used for those services that do not need to be accounted for in another fund.

*Special Revenue Funds* account for transactions related to resources obtained from specific revenue sources (other than expendable trusts or major capital projects) that are legally restricted to expenditures for specified purposes.

*Capital Projects Funds* account for transactions related to resources obtained and used to acquire or construct major capital facilities.

**Proprietary Fund Types** present financial data on activities that are similar to those found in the private sector. Users are charged for the goods or services provided. Pursuant to GASB Statement No. 20, the State applies all applicable GASB pronouncements as well as all applicable Financial Accounting Standards Board (FASB) Statements and Interpretations issued on or before November 30, 1989, unless the FASB Statements and Interpretations conflict with or contradict GASB pronouncements for its proprietary funds. However, the State has elected not to apply FASB Statements and Interpretations issued after November 30, 1989, with one exception. The exception is Prison Industries, an internal service fund, which has elected to follow FASB pronouncements issued after November 30, 1989, unless they conflict with or contradict GASB pronouncements. The State has two proprietary fund types.

*Enterprise Funds* account for goods or services provided to the general public on a continuing basis when (1) the State intends that all or most of the cost involved is to be financed by user charges, or (2) periodic measurement of the results of operations is appropriate for management control, accountability, capital maintenance, public policy, or other purposes.

*Internal Service Funds* account for goods or services provided to other agencies, departments, or governments on a cost-reimbursement basis.

**Fiduciary Fund Types** are used to account for assets held by the State. The State acts as a trustee or as an agent for individuals, private organizations, other governments, or other funds. The State has three fiduciary fund types.

*Expendable Trust Funds* account for assets held in a trustee capacity when both principal, income, and earnings on principal, may be expended in the course of a fund's designated operations.

*Pension Trust Funds* account for transactions, assets, liabilities, and net assets available for plan benefits of the retirement systems.

*Agency Funds* account for assets held by the State, which acts as an agent for individuals, private organizations, other governments, or other funds. They are custodial in nature and do not measure the results of operations.

**Account Groups** are used to establish control over and accountability for the government's general fixed assets and general long-term obligations. The State has two account groups.

*The General Fixed Assets Account Group* accounts for governmental fixed assets not reported in a proprietary fund or a trust fund.

*The General Long-Term Obligations Account Group* accounts for unmatured general obligation bonds and other long-term obligations generally expected to be financed from governmental funds.

**Discretely Presented Component Units** are reported in separate columns in the combined financial statements to emphasize that they are legally separate from the primary government. The discretely presented component units are classified as the University of California and as special purpose authorities. The University of California's financial statements are prepared in conformity with GAAP using the American Institute of Certified Public Accountants College Guide Model. As a result, the University of California's activities are accounted for in the following funds: Current Funds; Loan Funds; Endowment and Similar Funds; Plant Funds; and Retirement System Funds. Special purpose authorities account for their activities as enterprise funds.

**C. Measurement Focus and Basis of Accounting**

**Governmental Fund Types** and **Expendable Trust Funds** are presented using the flow of current financial resources measurement focus. With this measurement focus, operating statements present increases and decreases in net current assets; the unreserved fund balance is a measure of available spendable resources.

The accounts of the governmental fund types and expendable trust funds are reported using the modified accrual basis of accounting. Under the modified accrual basis, revenues are recorded as they become measurable and available, and expenditures are recorded at the time the liabilities are incurred. Principal tax revenues susceptible to accrual are recorded as taxpayers earn income (personal income and bank and corporation taxes), as sales are made (consumption and use taxes), and as the taxable event occurs (miscellaneous taxes), net of estimated tax overpayments. Other revenue sources are recorded when they are earned or when they are due, provided they are measurable and available within the ensuing 12 months.

Compensated absences are accounted for on a modified accrual basis of accounting. Except for expenditures in the General Fund for earned leave of academic-year faculty, compensated absences expenditures are not accrued since it is not anticipated that compensated absences will be used in excess of a normal year's accumulation.

**Agency Funds** are custodial in nature and do not measure the results of operations. Assets and liabilities are recorded using the modified accrual basis of accounting.

**Proprietary Fund Types and Pension Trust Funds** are accounted for on the flow of economic resources measurement focus.

The accounts of the proprietary fund types and pension trust funds are reported using the accrual basis of accounting. Under the accrual basis, revenues are recognized when they are earned, and expenses are recognized when they are incurred.

Lottery revenue and the related prize expense are recognized when sales are made. Certain prizes are payable in deferred installments. Such liabilities are recorded at the present value of amounts payable in the future.

For purposes of the statement of cash flows, all cash and pooled investments in the State Treasurer's Office pooled investment program, are considered to be cash and cash equivalents.

**Discretely Presented Component Units,** which are classified as the University of California and special purpose authorities, are accounted for on the flow of current resources and flow of economic resources measurement focus, respectively. All use the full accrual basis of accounting except for the SCIF. The SCIF prepares its financial statements in conformity with practices prescribed by the State's Department of Insurance, which is primarily in accordance with generally accepted accounting principles.

**D. Food Stamps**

The distribution of food stamp benefits is recognized as revenue and expenditures in a special revenue fund, as required by GAAP. Revenue and expenditures are recognized when the benefits are distributed to the recipients. Food stamp balances held by the counties are reported as an asset and offset by deferred revenue. Revenues, expenditures, and balances of food stamp benefits are measured based on face value.

**E. Inventories**

Inventories are primarily stated at either the lower of average cost or market, or at cost utilizing the weighted average valuation method. In governmental fund types, inventories are recorded as expenditures when purchased. In proprietary fund types, inventories are expensed when consumed.

The discretely presented component units have inventory policies similar to the primary government's.

**F. Net Investment in Direct Financing Leases**

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. The payments from these leases will be used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works

Board to finance the construction of facilities and energy efficiency projects. Upon expiration of these leases, jurisdiction of the facilities and projects will be with the primary government agency, Univers of California, or local agency. The State Public Works Board record the net investment in direct financing leases at the net present value of the minimum lease payments

**G. Deferred Charges**

The deferred charges account in the enterprise fund type primarily represents operating and maintenance costs and unrecovered capital costs that will be recognized as expenses over the remaining life of long-term state water supply contracts. These costs are billable in future years. In addition, the account includes unbilled interest earnings on unrecovered capital costs that are recorded as deferred charges. These charges are recognized when billed in future years under the terms of water supply contracts.

**H. Fixed Assets**

The **General Fixed Assets Account Group** includes capital assets that are not assets of any specific fund, but rather of the primary government as a whole. Most of these assets arise from the expenditure of the financial resources of governmental funds and expendable trust funds used to acquire or construct them. The General Fixed Assets Account Group does not include fixed assets of proprietary funds or pension trust funds. These fixed assets are accounted for in their respective funds.

The General Fixed Assets Account Group is presented in the financial statements at cost or estimated historical cost. Donated fixed assets are stated at fair market value at the time of donation. Interest during construction has not been capitalized. Also, public domain or "infrastructure" fixed assets are not capitalized. Accumulated depreciation is not recorded in the General Fixed Assets Account Group. Purchased fixed assets are stated at historical cost. Tangible and intangible property are capitalized if the property has a normal useful life of at least one year and an acquisition cost of at least $5,000.

**Proprietary Fund Type** fixed assets, consisting of property, plant, and equipment, are stated at cost at the date of acquisition, less accumulated depreciation. They are depreciated over their estimated useful or service lives, ranging from three to 100 years using the straight-line method of depreciation. Dormitory facilities, which represent 13.2% of the fixed assets of the enterprise funds, are not depreciated.

The fixed assets of the discretely presented component units are stated at cost at the date of acquisition, or fair market value at the date of donation in the case of gifts. Depreciation on the majority of the fixed assets of the discretely presented component units is not recorded, which is consistent with GAAP.

**I. Long-Term Obligations**

The primary government reports long-term obligations of governmental funds in the General Long-Term Obligations Acco Group. Long-term obligations consist of unmatured gene obligation bonds, certain unmatured revenue bonds, capital lease obligations, certificates of participation, commercial paper, the net pension obligation of the pension trust funds, the liability for employees' compensated absences and workers' compensation claims, amounts owed for lawsuits, and the primary government's share of the University of California pension liability.

With approval in advance from the Legislature, certain authorities and state agencies may issue revenue bonds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds, the building authorities, and agencies. The General Fund has no legal liability for payment of principal and interest on revenue bonds. With the exception of the building authorities, which are included in capital projects funds, the liability for revenue bonds is recorded in the respective fund.

**J. Compensated Absences**

In the governmental funds, only the amounts of compensated absences that normally would be liquidated with expendable available financial resources are accrued at year end, such as costs of academic year faculty. The costs of the academic-year faculty represent services rendered over a ten-month period that are paid over a 12-month period. The balance of the amounts owed for services rendered are reported as a current liability in the General Fund. Unless it is anticipated that compensated absences will be used in excess of a normal year's accumulation, no additional liabilities are accrued. As a result, the unpaid liability for governmental funds is recorded in the General Long-Term Obligations Account Group. Accumulated sick-leave balances are not included in the compensated absences because they do not vest to employees. However, unused sick-leave balances convert to service credits upon retirement.

The amounts of vested unpaid vacation and annual leave accumulated by state employees are accrued when incurred in proprietary funds. In the discretely presented component units, the compensated absences are accounted for in a similar manner as the proprietary funds in the primary government.

**K. Fund Equity**

Fund equity accounts present the difference between assets and liabilities of a fund. The fund equity accounts consist of *contributed capital* and *retained earnings* for proprietary funds and certain component units, *investment in general fixed assets* for the General Fixed Assets Account Group and certain component units, and *fund balance* for governmental funds, trust funds, and certain component units.

*Contributed capital* is the permanent fund capital of a proprietary fund. Contributed capital is created when a residual equity transfer is received by a proprietary fund, when a general fixed asset is "transferred" to a proprietary fund, or when a grant is received that is externally restricted to capital acquisition or construction.

*Retained earnings* is divided into two sections: *reserved for regulatory requirements* and *unreserved.* The reserved for regulatory requirements represent a segregation of the retained earnings enterprise funds and certain component units for amounts which are unavailable for general use as a result of specific legal requirements. Unreserved retained earnings represent the accumulated earnings of proprietary funds and certain component units that are not reserved for any specific purpose.

The fund balances for governmental funds and trust funds are divided into two sections: *reserved* and *unreserved-undesignated.* Part or all of the total fund balance may be reserved as a result of law or generally accepted accounting principles. Reserves represent those portions of the fund balances that are legally segregated for specific uses. The reserves of the fund balance for governmental funds, trust funds, and component units are as follows:

*Reserved for encumbrances* represents goods and services that are ordered, but not received, by the end of the year.

*Reserved for advances and loans receivable* represents advances to other funds and the non-current portion of loans receivable that do not represent expendable available financial resources.

*Reserved for employees' pension benefits* represents reserves of the pension trust funds and the University of California, a discretely presented component unit. These reserves include accumulated contributions made by employees and employers, and undistributed interest and investment earnings.

*Reserved for continuing appropriations* represents the unencumbered balance of all appropriations for which the period of availability extends beyond the period covered by this report. These appropriations are legally segregated for a specific future use.

*Reserved for other specific purposes* includes trust and agency fund amounts of the Unemployment Fund, other expendable trust funds, and the University of California, a discretely presented component unit, that are not available for future appropriations other than those for which the funds were established.

The *unreserved-undesignated* amounts represent the net of total fund balance, less reserves, for governmental funds and certain component units.

*Investment in general fixed assets* represents the fixed assets of the governmental funds and expendable trust funds reported in the General Fixed Assets Account Group and the fixed assets of the University of California, a discretely presented component unit, that are restricted for specific purposes.

**L. Restatement of Beginning Fund Equity**

The beginning retained earnings in the enterprise funds have been reduced by $490 million to correct prior year depreciation, amortization, deferred charges, and lease revenue accruals.

The beginning fund balance in the expendable trust funds has been reduced by $19 million to recognize a liability for future policy benefits that was not recorded during the year ended June 30, 1996.

The beginning fund balances of the University of California, a discretely presented component unit, have been increased by $28.8 billion as a result of the implementation of GASB Statement No. 25, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, and GASB Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools.

**M. Guaranty Deposits**

The State is custodian of guaranty deposits held to protect consumers, to secure the State's deposits in financial institutions, and to ensure payment of taxes and fulfillment of obligations to the State. Guaranty deposits of securities and other properties are not shown on the financial statements.

**N. Memorandum Only Total Columns**

Total columns captioned "memorandum only" do not represent consolidated financial information and are presented only to facilitate financial analysis. The columns do not present information that reflects financial position, results of operations, or cash flows in accordance with generally accepted accounting principles. Interfund eliminations have not been made in the aggregation of this data.

## NOTE 2. BUDGETARY AND LEGAL COMPLIANCE

**A. Budgeting and Budgetary Control**

The State's annual budget is prepared primarily on a modified accrual basis for governmental funds. The Governor recommends a budget for approval by the Legislature each year. This recommended budget includes estimated revenues; however, revenues are not included in the budget adopted by the Legislature. Under state law, the State cannot adopt a spending plan that exceeds estimated revenues.

Under the State Constitution, money may be drawn from the treasury only through a legal appropriation. The appropriations contained in the Budget Act, as approved by the Legislature and signed by the Governor, are the primary sources of annual expenditure authorizations and establish the legal level of control at the appropriation level for the annual operating budget. The budget can be amended throughout the year by special legislative action, budget revisions by the Department of Finance, or executive orders by the Governor.

Amendments to the initial budget for the year ended June 30 were legally made, and are included in the budget data in the financial statements. The amendments had the effect of increasing spending authority and expenditures for the year.

Appropriations are generally available for expenditure or encumbrance either in the year appropriated or for a period of three years if the legislation does not specify a period of availability. At the end of the availability period, the encumbering authority for the unencumbered balance lapses. Some appropriations continue indefinitely while others are available until fully spent. Generally, encumbrances must be liquidated within two years from the end of the period when the appropriation is available. If the encumbrances are not liquidated within this additional two-year period, the spending authority for these encumbrances lapses.

Legislative appropriations are based on when commitments for goods and services are incurred. However, for financial reporting purposes, the State reports expenditures based on the year goods and services are received. The budgets reported in the Statements of Revenues, Expenditures, and Changes in Fund Balances Budgetary Basis-Budget and Actual, have been adjusted to reflect the differences between the financial reporting methodology and legislative appropriations to correctly state the budget variance. These statements include all the expenditures of the governmental funds and their related appropriations that are authorized annually, continually, or by project. Governmental funds that are budgeted annually include the General Fund, special revenue funds, and capital projects funds.

**B. Legal Compliance**

State agencies are responsible for exercising basic budgetary control and ensuring that appropriations are not overspent. The State Controller's Office is responsible for overall appropriation control and does not allow expenditures in excess of authorized appropriations.

A prior year revenue adjustment occurs when the actual amount received in the current year differs from the prior year accrual of revenues. A prior year expenditure adjustment results when the actual amount paid in the current year differs from the prior year accrual, for appropriations whose ability to encumber funds has lapsed in previous periods. The effect of prior year expenditure adjustments is not included in the budget figures shown for the special revenue and capital projects funds on the budgetary basis. However, the actual figures for those funds on the budgetary basis include prior year expenditure and revenue adjustments. Since these adjustments can be either positive or negative, the budget to actual statement may show unfavorable balances for special revenue and capital projects funds, even though the appropriation has not been overexpended.

In contrast, prior year expenditure and revenue adjustments are not included in the actual figures for the General Fund on the budgetary basis. Rather, the beginning fund balance of the General Fund on a budgetary basis was increased by $30 million. This adjustment reflects the total of the General Fund prior year adjustments for expenditures and revenues. The beginning fund balance on the GAAP basis is not affected by these adjustments.

A fund was reclassified from capital projects to special revenue. The reclassification resulted in no change to the beginning fund balance of the financial statements prepared in accordance with generally accepted accounting principles. However, the beginning budgetary basis fund balance of the special revenue funds was increased by $2 billion and the beginning balance of the capital projects funds was decreased by $2 billion to reflect the reclassification of the funds' budgetary basis fund balance.

Financial activities are mainly controlled at the appropriation level but can vary depending on the presentation and wording contained in the Budget Act. Certain items which are established at the category, program, component, or element levels can be adjusted by the Department of Finance. While the financial activities are controlled at various levels, the legal level of budgetary control has been established in the Budget Act at the appropriation level for the annual operating budget.

The Combined Statement of Revenues, Expenditures, and Changes in Fund Balances Budgetary Basis-Budget and Actual, and the related combining level and individual fund presentations are not presented in this document at the legal level of budgetary control, as such a presentation would be extremely lengthy and cumbersome. The State of California prepares a separate report, the *Budgetary/Legal Basis Annual Report Supplement*, which includes a statement that demonstrates compliance with the legal level of budgetary control, in accordance with GASB's Codification of Governmental Accounting and Financial Reporting Standards Section 2400.112. This statement, the Statement of Appropriations, Expenditures, and Balances does not include all of the expenditures and appropriations of the governmental funds. However, it does include the comparison of the annual appropriated budget for governmental funds with expenditures at the legal level of control. A copy of this report is available from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5876.

**C. Reconciliation of Budgetary Basis with GAAP Basis**

The State annually reports its financial condition based on GAAP (GAAP basis) and on the State's budgetary provisions (budgetary basis). The Statements of Revenues, Expenditures, and Changes in Fund Balances Budgetary Basis-Budget and Actual are compiled on the budgetary basis for the governmental funds. The differences between budgetary basis fund balances and the fund balances prepared in accordance with GAAP are explained and reconciled in the following paragraphs and Table 1.

*Advances and Loans Receivable:* Loans made to other funds or to other governments are normally recorded as expenditures on the budgetary basis. However, in accordance with GAAP, these loans are recorded as assets.

The General Fund had education loans outstanding as of June 30, 1997, of $885 million that will be forgiven and charged to expenditures in the year of appropriation on a budgetary basis. On a GAAP basis, these education loans were charged to expenditures for the year ended June 30, 1996, which was the year that the agreement was made to forgive the loans.

The adjustments related to advances and loans caused a decrease to the fund balance of $790 million in the General Fund and an increase to the fund balance of $1.3 billion in special revenue funds.

*Escheat Property:* Liability for the estimated amount of escheat property ultimately expected to be reclaimed and paid is required to be reported. This adjustment caused a $436 million decrease to the General Fund balance.

*Liabilities Exceeding Available Appropriations:* The primary government does not, on a budgetary basis, accrue liabilities for which there is no existing appropriation or no currently available appropriation. The adjustments made to this account for these liabilities in accordance with GAAP caused a net decrease to the General Fund balance of $1.6 billion. This amount is comprised of accrued employer contributions of $1.5 billion to the Public Employees' Retirement Fund for the years ending June 30, 1996 and 1997, and $55 million expenditure used for support of the University of California.

*Authorized and Unissued Bonds:* General obligation bonds that are not self-liquidating are recorded as additions to the fund balance for the special revenue and capital projects funds on the budgetary basis when voters authorize the sale of bonds. However, in accordance with GAAP, only the bonds issued during the year are recorded as bond proceeds. The adjustments related to authorized and unissued bonds caused a decrease to fund balance of $5.3 billion in special revenue funds and $1.4 billion in capital projects funds.

*Encumbrances:* The State does not record certain encumbrances on a budgetary basis that are recorded on a GAAP basis. The adjustments related to encumbrances caused an increase to the fund balance of $401 million in special revenue funds.

*Other:* Certain other adjustments and reclassifications are necessary to present the financial statements in accordance with GAAP. The other adjustments caused a decrease in fund balance of $295 million in the General Fund, $638 million in special revenue funds, and an increase in fund balance of $120 million in capital projects funds.

**Table 1**

**Reconciliation of Budgetary Basis and GAAP Basis Fund Balances**
June 30, 1997
(Amounts in thousands)

| Reconciliation Items | General Fund | Special Revenue Funds | Capital Projects Funds |
|---|---|---|---|
| **Budgetary Basis** | **$ 639,843** | **$ 10,071,216** | **$ 1,436,213** |
| Advances and loans receivable | (789,631) | 1,325,726 | — |
| Escheat property | (435,546) | — | — |
| Liabilities exceeding available appropriations | (1,596,879) | — | — |
| Authorized and unissued bonds | — | (5,288,005) | (1,358,069) |
| Encumbrances | — | 401,347 | — |
| Other | (294,678) | (637,528) | 119,704 |
| **GAAP Basis (Deficit)** | **$ (2,476,891)** | **$ 5,872,756** | **$ 197,848** |

## NOTE 3. DEPOSITS AND INVESTMENTS

State statutes, bond resolutions, and investment policy resolutions allow the primary government to have investments in United States government securities, certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, mortgage loans and notes, other debt securities, repurchase agreements, reverse repurchase agreements, equity securities, real estate, mutual funds, and other investments.

As of June 30, the State, including discretely presented component units, had investments in securities lending agreements, real estate, investment contracts, mutual funds, and other investments totaling $48.4 billion. These investments are not subject to classification. All remaining investments reported as of June 30, are categorized in three categories of credit risk:

1. Insured or registered, or securities held by the State or its agent in the State's name.
2. Uninsured and unregistered, with securities held by the counterparty's trust department or by an agent in the State's name.
3. Uninsured and unregistered, with securities held by the counterparty or by its trust department or by an agent but not in the State's name.

The types of investments reported at year end are representative of the types of investments made during the year. Furthermore, the credit risk associated with the investments reported at year end is representative of the credit risk associated with investments made during the year.

The State Treasurer's Office administers a pooled investment program for the primary government and for certain special purpose authorities. As of June 30, the special purpose authorities' cash and pooled investments were approximately 3% of the State Treasurer's Office pooled investment portfolio. This program enables the State Treasurer's Office to combine available cash from all funds and to invest cash that exceeds current needs. Enterprise funds, trust and agency funds, and a building authority in the capital projects funds also make separate investments.

As of June 30, the average remaining life of the securities in the pooled money investment account administered by the State Treasurer's Office was approximately 232 days.

The State Treasurer's Office also has agreements with certain banks to maintain cash on deposit that does not earn interest income. Income earned on these deposits compensates the banks for services and uncleared checks that are deposited in the pooled investment program's accounts.

All demand and time deposits, totaling approximately $664 million, which were held by financial institutions as of June 30, were insured by federal depository insurance or by collateral held by the State Treasurer's Office or by an agent of the State Treasurer's Office in the State's name. The California Government Code requires collateral pledged for demand and time deposits to be deposited with the State Treasurer.

As of June 30, the State Treasurer's Office had amounts on deposit with fiscal agents totaling approximately $10 million. These deposits are related to primary government investment activities and to principal and interest payments due to bondholders. These deposits are insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

The investments of pension trust funds are reported at fair value. Investments of the Deferred Compensation Plan Fund, an agency fund, are reported at market value. All other investments are reported at cost or amortized cost. For these investments, no loss is recorded when market values decline below cost, as such declines are considered temporary.

As of June 30, floating rate notes and mortgage-backed assets comprised less than 5% of the pooled investments. For the floating rate notes in the portfolio, the interest received by the State Treasurer's Office pooled investment program will rise or fall as the underlying index rate rises or falls. The structure of the floating rate notes in the State Treasurer's Office pooled investment program portfolio is such that it hedges the portfolio against the risk of increasing interest rates. The mortgage-backed securities are called real estate mortgage investment conduits (REMICs). A REMIC is a security backed by a pool of mortgages. The REMICs in the State portfolio have a fixed principal payment schedule.

The California Government Code allows the State Treasurer's Office to enter into reverse repurchase agreements, as part of its pooled investment program. A reverse repurchase agreement is a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The market value of the securities underlying reverse repurchase agreements normally exceeds the cash received, providing the dealers a margin against a decline in market value of the securities. If the dealers default on their obligations to resell these securities to the State Treasurer's Office or provide securities or cash of equal value, the State Treasurer's Office pooled investment program will suffer an economic loss equal to the difference between the market value plus the accrued interest of the underlying securities and the agreement obligation, including accrued interest. During the year ended June 30, the State Treasurer's Office entered into 28 reverse repurchase agreements by temporarily selling investments with a carrying value of approximately $4.4 billion. The maturities of investments made with the proceeds from reverse repurchase agreements were matched to the maturities of the agreements. As of June 30, the State Treasurer's Office did not have any reverse repurchase agreements outstanding.

State statutes and agency policies permit CalPERS and STRS to lend its securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. Third party securities lending agents have been contracted to lend domestic and international equity and debt securities. All securities loans can be terminated on demand by the lender or the borrower. Collateral in the form of cash or other securities is required at 102% and 105% of the fair value of domestic and international securities loaned, respectively. As of June 30, 1997, there was no credit risk of exposure to borrowers because the amount of collateral held exceeded the amounts owed to the borrowers. The cash received as collateral is invested in accordance with investment guidelines. The weighted-average maturity of all investments of the cash collateral was less than 90 days as of June 30. Collateral securities received are not permitted to be pledged or sold unless the borrower defaults. The contracts with the security lending agents require them to indemnify CalPERS and STRS if the borrowers fail to return the securities (or if the collateral is not sufficient to replace the securities lent) or if the borrower fails to pay for income distributions by the securities' issuers while the securities are on loan.

In accordance with statutes authorizing CalPERS investments, CalPERS, through its outside investment managers, holds investments in futures and options and enters into forward foreign currency exchange contracts. Futures and options of approximately $92 million are held for investment purposes as of June 30, 1997. Gains and losses on futures and options are determined based upon quoted market values and recorded in the statement of changes in net assets. Forward foreign currency exchange contracts are used primarily to hedge against changes in exchange rates related to foreign securities. As of June 30, 1997, CalPERS had approximately $91 million net exposure to loss from forward foreign currenc exchange transactions related to the $26.9 billion international del and equity portfolios. CalPERS could be exposed to risk if the counterparties to the contracts are unable to meet the terms of the contracts. CalPERS investment managers seek to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, and exposure monitoring procedures. CalPERS anticipates that the counterparties will be able to satisfy their obligations under the contracts.

Table 2 presents the carrying value and market value of the investments that were reported by the primary government as of June 30.

**Table 2**

**Schedule of Investments - Primary Government**
June 30, 1997
(Amounts in thousands)

| | Category 1 | Category 2 | Category 3 | Carrying Value | Market Value |
|---|---|---|---|---|---|
| **Pooled Investments** * | | | | | |
| U.S. Government securities | $ 8,745,859 | $ — | $ — | $ 8,745,859 | $ 8,745,635 |
| Deposits | 6,832,540 | — | — | 6,832,540 | 6,831,485 |
| Bankers' acceptances | 870,395 | — | — | 870,395 | 871,718 |
| Commercial paper | 6,782,756 | — | — | 6,782,756 | 6,785,493 |
| Corporate bonds | 1,569,890 | — | — | 1,569,890 | 1,567,125 |
| Bank notes | 949,074 | — | — | 949,074 | 948,889 |
| Other | 29,495 | — | — | 29,495 | 29,495 |
| **Total Pooled Investments** | **25,780,009** | **—** | **—** | **25,780,009** | **25,779,840** |
| **Separately Invested Funds Subject to Categorization** | | | | | |
| U.S. Government securities | 8,991,927 | 134,512 | — | 9,126,439 | 9,341,905 |
| Commercial paper | 2,334,124 | — | — | 2,334,124 | 2,334,124 |
| Corporate bonds | 6,303,615 | 764 | — | 6,304,379 | 6,303,781 |
| Mortgage loans | 13,244,530 | — | — | 13,244,530 | 13,244,530 |
| Debt securities – STRS | 14,131,637 | — | — | 14,131,637 | 14,131,637 |
| Equity securities | 110,530,849 | — | — | 110,530,849 | 110,530,849 |
| Securities lending collateral | 25,122,038 | — | — | 25,122,038 | 25,122,038 |
| Other investments | 4,418,027 | — | — | 4,418,027 | 4,418,028 |
| **Total Separately Invested Funds Subject To Categorization** | **185,076,747** | **135,276** | **—** | **185,212,023** | **185,426,892** |
| **Separately Invested Funds Not Subject to Categorization** | | | | | |
| Real estate | | | | 8,384,488 | 8,384,488 |
| Venture capital and private equity funds | | | | 2,722,170 | 2,722,170 |
| Investment contracts | | | | 2,045,877 | 2,045,877 |
| Mutual funds | | | | 1,758,886 | 1,760,248 |
| Investments held by broker-dealers under securities loans with cash collateral | | | | 24,378,763 | 24,378,763 |
| Other | | | | 1,393,270 | 1,393,270 |
| **Total Separately Invested Funds Not Subject to Categorization** | | | | **40,683,454** | **40,684,816** |
| **Total Investments** | **$ 210,856,756** | **$ 135,276** | **$ —** | **$ 251,675,486** | **$ 251,891,548** |

* Approximately 3% of the pooled investments are investments of special purpose authorities which are discretely presented component units. For special purpose authorities' separately invested funds, see Table 4.

The investments of the University of California, a discretely presented component unit, are stated at fair value. All of the University's investments recorded in each fund group are associated with the University of California Retirement System (UCRS), General Endowment Pool (GEP), High Income Pool (HIP), Short Term Investment Pool (STIP) or are separately invested. Investments authorized by the Regents for the UCRS, GEP, HIP, and other separate investments include equities and fixed income securities. The equity portion of the investment portfolio may include common stocks, preferred stocks, venture capital partnerships, and emerging market funds. Where donor agreements place constraints on allowable investments, assets associated with endowment and similar funds are invested in accordance with the terms of the agreements. Investments authorized by the Regents for the STIP include fixed income securities with a maximum maturity of five years. In addition, the Regents have also authorized loans to faculty members under the University of California's Mortgage Origination Program with terms up to 30 years.

The GEP and HIP are balanced portfolios in which a large number of individual endowment funds participate in order to benefit from diversification and economies of scale. The net assets of the endowment and similar funds group are invested in either the GEP, HIP, STIP or are separately invested. The separately invested funds cannot be pooled due to investment restrictions or income requirements. All of the University of California's fund groups participate in the STIP. Current funds to provide for the payroll, operating expenses, and construction expenditures of all campuses and medical centers are invested in the STIP until expended.

UCRS contains funds associated with the University of California's defined benefit and defined contribution plans.

The University of California participates in a securities lending program as a means to augment income. Securities are lent to select brokerage firms for which collateral is received in excess of the fair value of such investments during the period of the loan. Collateral may be cash or securities issued by the U. S. Government or its agencies, or the sovereign or provincial debt of foreign countries. Any collateral securities cannot be pledged or sold by the University unless the borrower defaults. Loans of domestic equities and all fixed income securities are initially collateralized at 102 percent of the fair value of securities lent. Loans of foreign equities are initially collateralized at 105 percent. All borrowers are required to provide additional collateral by the next business day if the value falls to less than 100 percent of the fair value of securities lent. The University receives interest and dividends during the loan period as well as a fee from the brokerage firm. Securities on loan for cash collateral are not considered to be categorized. As of June 30, the University had no credit risk exposure to borrowers because the amounts the University owes the borrowers exceed the amounts the borrowers owe the University. The University is fully indemnified by its custodial bank against any losses incurred as a result of borrower default.

Securities loans immediately terminate upon notice by either the University or the borrower, although generally the average term of these loans is six days. Cash collateral is invested by the University's lending agent, as an agent for the University, in a short term investment pool in the University's name, with guidelines approved by the Treasurer of the Regents. As of June 30, the securities in this pool had a weighted average maturity of 47 days. Table 3 presents the carrying and market value of the investmen that were reported by the University of California as of June 30.

**Table 3**

**Schedule of Investments – University of California – Discretely Presented Component Unit**
June 30, 1997
(Amounts in thousands)

| | Category 1 | Category 2 | Category 3 | Carrying Value | Market Value |
|---|---|---|---|---|---|
| **Separately Invested Funds Subject to Categorization** | | | | | |
| U.S. Government securities | $ 2,030,089 | $ — | $ — | $ 2,030,089 | $ 2,030,089 |
| Corporate bonds | 4,253,439 | — | — | 4,253,439 | 4,253,439 |
| Equity securities | 23,429,103 | — | — | 23,429,103 | 23,429,103 |
| Securities lending collateral | 5,450,981 | — | — | 5,450,981 | 5,450,981 |
| Other investments | 4,584,034 | — | — | 4,584,034 | 4,584,034 |
| **Total Separately Invested Funds Subject to Categorization** | **39,747,646** | **—** | **—** | **39,747,646** | **39,747,646** |
| **Separately Invested Funds Not Subject to Categorization** | | | | | |
| Venture capital and private equity funds | | | | 966,561 | 966,561 |
| Mortgage loans | | | | 208,035 | 208,035 |
| Insurance contracts | | | | 277,763 | 277,763 |
| Investments held by broker-dealers under securities loans with cash collateral | | | | 5,323,888 | 5,323,888 |
| Other investments | | | | 41,692 | 41,692 |
| **Total Separately Invested Funds Not Subject to Categorization** | | | | **6,817,939** | **6,817,939** |
| **Total Investments** | **$ 39,747,646** | **$ —** | **$ —** | **$ 46,565,585** | **$ 46,565,585** |

The cash and pooled investments of the special purpose authorities, which are discretely presented component units, are primarily invested in the State Treasurer's Office pooled investment program. Additionally, state law, bond resolutions, and investment policy resolutions allow the authorities to invest in United States government securities, state and municipal securities, commercial paper, corporate bonds, investment agreements, and other investments.

Table 4 presents the carrying value and market value of the investments outside of the State Treasurer's Office pooled investment program of the special purpose authorities as of June 30, 1997, with the exception of the SCIF. Included in the investments of the special purpose authorities are the investments of the SCIF as of December 31, 1996. The SCIF represents 82% of the carrying value and 82% of the market value of the authorities' investments.

**Table 4**

**Schedule of Investments - Special Purpose Authorities – Discretely Presented Component Units ***
June 30, 1997
(Amounts in thousands)

| | Category 1 | Category 2 | Category 3 | Carrying Value | Market Value |
|---|---|---|---|---|---|
| **Separately Invested Funds Subject to Categorization** | | | | | |
| U.S. Government securities | $ 2,447,441 | $ — | $ — | $ 2,447,441 | $ 2,636,046 |
| Investment agreements | 29,707 | 240,739 | — | 270,446 | 270,446 |
| Commercial paper | 57,813 | — | — | 57,813 | 57,666 |
| Mortgage loans and notes | 1,189,324 | — | — | 1,189,324 | 1,199,310 |
| Corporate bonds | 1,995,000 | — | — | 1,995,000 | 2,022,122 |
| Other investments | 60,815 | — | — | 60,815 | 61,847 |
| **Total Separately Invested Funds Subject to Categorization** | **5,780,100** | **240,739** | **—** | **6,020,839** | **6,247,437** |
| **Separately Invested Funds Not Subject to Categorization** | | | | | |
| Mutual funds | | | | 66,032 | 66,032 |
| Investment agreements | | | | 827,683 | 827,683 |
| **Total Separately Invested Funds Not Subject to Categorization** | | | | **893,715** | **893,715** |
| **Total Investments** | **$ 5,780,100** | **$ 240,739** | **$ —** | **$ 6,914,554** | **$ 7,141,152** |

* For special purpose authorities' pooled investments, see Table 2.

## NOTE 4. DUE FROM OTHER FUNDS, DUE TO OTHER FUNDS, ADVANCES AND LOANS RECEIVABLE, ADVANCES FROM OTHER FUNDS, DUE FROM PRIMARY GOVERNMENT, AND DUE TO COMPONENT UNITS

The balances of Due from Other Funds, Due to Other Funds, Advances and Loans Receivable, Advances from Other Funds, Due from Primary Government, and Due to Component Units are shown in Table 5.

The total Advances and Loans Receivable is $9.4 billion more than the total Advances from Other Funds, because loans to other governmental entities and individuals are included in the loans receivable amounts. The total Due to Component Units is $211 million more than the total Due from Primary Government because of accounting practices of the SCIF, a discretely presented component unit. The SCIF has not recorded $211 million as Due from Primary Government for reimbursement of the amount of claims received as of June 30 and expected to be paid in the following year.

## Table 5

**Schedule of Due from Other Funds, Due to Other Funds, Advances and Loans Receivable, Advances from Other Funds, Due from Primary Government, and Due to Component Units**

June 30, 1997 (Amounts in thousands)

| | Due from Other Funds | Due to Other Funds | Advances and Loans Receivable | Advances from Other Funds | Due from Primary Government | Due to Component Units |
|---|---|---|---|---|---|---|
| **General Fund** | $ 4,544,474 | $ 4,530,496 | $ 670,060 | $ 544,371 | $ — | $ 163,040 |
| **Special Revenue** | | | | | | |
| Federal | 112,264 | 3,536,460 | 32,918 | — | — | 5,563 |
| Transportation Construction | 1,556,351 | 326,482 | 114,985 | — | — | 22,204 |
| Transportation Safety | 58,195 | 138,558 | — | — | — | 207 |
| Business and Professions Regulatory and Licensing | 87,178 | 57,206 | 1,533 | 14,673 | — | 31,083 |
| Environmental and Natural Resources | 199,667 | 89,858 | 1,130,343 | 35,107 | — | 208 |
| Financing to Local Governments | 11,728 | 4,952 | — | — | — | — |
| Cigarette and Tobacco Tax | 166,280 | 110,829 | — | — | — | 85,269 |
| Local Revenue | 204,991 | 15,081 | — | — | — | — |
| Unemployment Programs | 372,073 | 44,420 | — | — | — | 3,384 |
| Financing to the Public | 472 | 398 | 41,209 | — | — | — |
| Other Special Revenue | 160,927 | 74,943 | 4,738 | 11,648 | — | 6,643 |
| **Total Special Revenue** | **2,930,126** | **4,399,187** | **1,325,726** | **61,428** | **—** | **154,561** |
| **Capital Projects** | | | | | | |
| Special Account for Capital Outlay | 300 | 1,456 | — | — | — | — |
| Prison Construction | 939 | 1,486 | — | — | — | — |
| Higher Education Construction | 1,849 | 7,885 | — | — | — | — |
| Natural Resources Acquisition and Enhancement | 7,926 | 1,848 | — | — | — | — |
| Building Authorities | 28,511 | 21,468 | — | — | — | — |
| Other Capital Projects | 1,363 | 724 | — | — | — | — |
| **Total Capital Projects** | **40,888** | **34,867** | **—** | **—** | **—** | **—** |
| **Enterprise** | | | | | | |
| Housing Loan | 5,395 | 2,390 | 2,215,650 | 84,260 | — | — |
| Water Resources | 72,147 | 34,612 | 76,558 | 25,143 | — | — |
| School Building Aid | — | 56,128 | 237,140 | — | — | 1,556 |
| Toll Facilities | 8,842 | 21,391 | 5,759 | 6,160 | — | — |
| California State University | 13,010 | 15,464 | 3,243 | 2,663 | — | — |
| Leasing of Public Assets | 138,751 | 16,557 | — | — | — | 1,023 |
| State Lottery | 8,118 | 179,120 | — | — | — | — |
| Harbors and Watercraft | 3,230 | 9,081 | 200,757 | — | — | — |
| Health Facilities Construction Loan Insurance | 3,849 | 933 | — | — | — | — |
| Other Enterprise | 7,171 | 2,099 | 29,214 | 4,738 | — | — |
| **Total Enterprise** | **260,513** | **337,775** | **2,768,321** | **122,964** | **—** | **2,579** |
| **Internal Service** | | | | | | |
| Architecture Revolving | 76,556 | 2,361 | — | — | — | 812 |
| Service Revolving | 79,324 | 93,546 | — | — | — | 11,630 |
| Prison Industries | 18,323 | 4,185 | — | 1,181 | — | 6,100 |
| Stephen P. Teale Data Center | 10,370 | 394 | — | — | — | 634 |
| Health and Welfare Agency Data Center | 8,761 | 2,478 | — | — | — | — |
| Water Resources | 61,832 | 13 | — | 91,877 | — | 936 |
| Other Internal Service | 10,052 | 6,296 | — | 1,533 | — | — |
| **Total Internal Service** | **265,218** | **109,273** | **—** | **94,591** | **—** | **20,112** |

(Continued)

**Table 5 (continued)**

**Schedule of Due from Other Funds, Due to Other Funds, Advances and Loans Receivable, Advances from Other Funds, Due From Primary Government, and Due to Component Units**

June 30, 1997 (Amounts in thousands)

| | Due from Other Funds | Due to Other Funds | Advances and Loans Receivable | Advances from Other Funds | Due from Primary Government | Due to Component Units |
|---|---|---|---|---|---|---|
| **Expendable Trust** | | | | | | |
| Unemployment | 18,793 | 108,742 | — | — | — | — |
| School Employees | 2,080 | 4,676 | — | — | — | — |
| Unemployment Compensation Disability | 71,129 | 19,214 | — | — | — | — |
| California State University and Colleges Trust | 57,386 | 10,827 | — | — | — | — |
| State Guaranteed Loan Reserve | 5,113 | 850 | — | — | — | — |
| Housing Loan | 3,768 | 890 | 592,850 | — | — | — |
| Unclaimed Property Fund | — | — | 435,546 | — | — | — |
| Public Employees Health Care | 5,934 | 786 | — | — | — | — |
| Other Expendable Trust | 75,938 | 11,942 | — | — | — | — |
| **Total Expendable Trust** | 240,141 | 157,927 | 1,028,396 | — | — | — |
| **Pension Trust** | | | | | | |
| Public Employees' Retirement | 1,538,429 | — | — | — | — | — |
| Judges' Retirement | — | 781 | — | — | — | — |
| Judges' Retirement II | 753 | — | — | — | — | — |
| Legislators' Retirement | — | 198 | — | — | — | — |
| Volunteer Firefighters' Length of Service | — | 10 | — | — | — | — |
| **Total Pension Trust** | 1,539,182 | 989 | — | — | — | — |
| **Agency** | | | | | | |
| Local Agency Investment | 154,831 | 111,798 | — | — | — | — |
| Revenue Collecting and Disbursing | 5,803,490 | 5,520,207 | 534,071 | 534,071 | — | — |
| Deposit | 21,433 | 495,443 | 21,144 | — | — | — |
| Deferred Compensation Plan | 209 | 158 | — | — | — | — |
| Departmental Trust | 4,273 | 680 | — | — | — | — |
| Other Agency | 219,614 | 326,141 | — | — | — | 2,431 |
| **Total Agency** | 6,203,850 | 6,454,427 | 555,215 | 534,071 | — | 2,431 |
| **University of California** | | | | | | |
| Current Funds | 9,409 | 124,673 | — | — | 127,880 | — |
| Loan Funds | — | 2,000 | — | — | — | — |
| Endowment and Similar Funds | 16,763 | 9,284 | — | — | — | — |
| Plant Funds | 1,533 | 16,421 | — | — | — | — |
| Retirement System Funds | 124,673 | — | — | — | — | — |
| **Total University of California** | 152,378 | 152,378 | — | — | 127,880 | — |
| **Special Purpose Authorities** | | | | | | |
| Housing Finance Agency | — | — | 4,360,172 | — | — | — |
| Pollution Control | — | — | — | — | 2,707 | — |
| Health Facilities | — | — | — | — | 589 | — |
| Educational Facilities | — | — | — | — | 145 | — |
| Economic Development | — | — | — | — | 13 | — |
| District Agricultural Associations | 549 | — | — | — | — | — |
| **Total Special Purpose Authorities** | 549 | — | 4,360,172 | — | 3,454 | — |
| **Total** | $ 16,177,319 | $ 16,177,319 | $ 10,707,890 | $ 1,357,425 | $ 131,334 | $ 342,723 |

(Concluded)

## NOTE 5. RESTRICTED ASSETS

Table 6 presents a summary of the legal restrictions on assets as of June 30. The restricted assets of the primary government are in the enterprise funds except for $700,000 that are in the internal service funds.

**Table 6**

**Schedule of Restricted Assets**
June 30, 1997
(Amounts in thousands)

| | Cash and Pooled Investments | Investments | Due From Other Funds | Other Assets |
|---|---|---|---|---|
| **Primary Government** | | | | |
| Debt service | $ 561,274 | $ 98,113 | $ 159 | $ 1,464 |
| Construction | 654,052 | — | 8,257 | 776 |
| Deposits | 6,332 | — | — | — |
| Equipment repair and replacement | 57,896 | — | 637 | 92 |
| Operations | 12,644 | — | — | — |
| Other | 18,067 | — | — | — |
| **Total Primary Government** | 1,310,265 | 98,113 | 9,053 | 2,332 |
| **Discretely Presented Component Units** | | | | |
| **University of California** | | | | |
| Risk insurance | — | 251,446 | — | — |
| Debt service requirements | — | 193,218 | — | — |
| Plant acquisition, construction, and renovation | — | 146,487 | — | — |
| Plant renewal and replacement | — | 453 | — | — |
| **Special Purpose Authorities** | | | | |
| Debt service | 337,633 | 1,183,475 | — | — |
| **Total Discretely Presented Component Units** | 337,633 | 1,775,079 | — | — |
| **Total All Restricted Assets** | $ 1,647,898 | $ 1,873,192 | $ 9,053 | $ 2,332 |

## NOTE 6. NET INVESTMENT IN DIRECT FINANCING LEASES

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. Payments from these leases will be used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board.

The minimum lease payments to be received by the State Public Works Board for the primary government are summarized in Table 7.

**Table 7**

**Schedule of Minimum Lease Payments to be Received by the State Public Works Board for the Primary Government**
(Amounts in thousands)

| Year Ending June 30 | Primary Government Agencies | University of California | Local Agencies | Total |
|---|---|---|---|---|
| 1998 | $ 322,306 | $ 98,590 | $ 57,837 | $ 478,733 |
| 1999 | 313,634 | 99,773 | 61,010 | 474,417 |
| 2000 | 312,316 | 100,042 | 61,038 | 473,396 |
| 2001 | 299,735 | 96,839 | 59,635 | 456,209 |
| 2002 | 296,498 | 92,888 | 55,588 | 444,974 |
| Thereafter | 3,631,802 | 1,350,919 | 702,366 | 5,685,087 |
| **Total Minimum Lease Payments** | **5,176,291** | **1,839,051** | **997,474** | **8,012,816** |
| Less unearned income | 2,347,345 | 909,052 | 487,067 | 3,743,464 |
| **Net Investment in Direct Financing Leases** | **$ 2,828,946** | **$ 929,999** | **$ 510,407** | **$ 4,269,352** |

## NOTE 7. FIXED ASSETS

Table 8 is a summary of changes in the General Fixed Assets Account Group for the year ended June 30.

**Table 8**

**Schedule of Changes in General Fixed Assets**
(Amounts in thousands)

| | Balance July 1, 1996 | Additions | Deductions | Balance June 30, 1997 |
|---|---|---|---|---|
| Land | $ 1,957,254 | $ 85,758 | $ 70,258 | $ 1,972,754 |
| Structures and improvements | 10,063,599 | 1,089,713 | 496,274 | 10,657,038 |
| Equipment | 2,232,731 | 429,891 | 444,387 | 2,218,235 |
| Construction in progress | 774,374 | 729,764 | 396,872 | 1,107,266 |
| **Total** | **$ 15,027,958** | **$ 2,335,126** | **$ 1,407,791** | **$ 15,955,293** |

Table 9 summarizes the proprietary fund fixed assets of enterprise funds and internal service funds, and the fixed assets of the discretely presented component units as of June 30.

**Table 9**

**Schedule of Fixed Assets for Proprietary Funds and Discretely Presented Component Units**
June 30, 1997
(Amounts in thousands)

| Primary Government | Enterprise | Internal Service |
|---|---|---|
| State water projects | $ 3,500,468 | $ — |
| Toll facilities | 1,017,909 | — |
| Other land, improvements, buildings and equipment | 1,002,513 | 552,087 |
| Construction in progress | 1,702,632 | 1,938 |
| **Total Primary Government Fixed Assets** | **7,223,522** | **554,025** |
| Less: accumulated depreciation | 1,792,124 | 306,819 |
| **Net Primary Government Fixed Assets** | **$ 5,431,398** | **$ 247,206** |

| Discretely Presented Component Units | University of California | Special Purpose Authorities |
|---|---|---|
| Real estate | | |
| Buildings and improvements | $ 7,742,946 | $ 537,424 |
| Land | 260,564 | 46,265 |
| Furniture and equipment | 3,264,012 | 104,299 |
| Libraries and collections | 2,125,812 | — |
| Construction in progress | 913,280 | 310 |
| **Total Discretely Presented Component Unit Fixed Assets** | **14,306,614** | **688,298** |
| Less: accumulated depreciation | — | (114,072) |
| **Net Discretely Presented Component Unit Fixed Assets** | **$ 14,306,614** | **$ 574,226** |

## NOTE 8. LONG-TERM OBLIGATIONS

As of June 30, the primary government had long-term obligations totaling $21.4 billion. These obligations are not expected to be financed from current resources in the governmental funds. Long-term obligations consist of the liability for employees' compensated absences, certificates of participation and commercial paper, long-term capital lease obligations, unmatured general obligation bonds, unmatured revenue bonds, and other liabilities. These other liabilities consist of the liability for workers' compensation claims of $672 million, the liability for net pension obligations of $556 million, amounts owed for lawsuits of $320 million, and the University of California pension liability of $106 million. These other liabilities do not have any required payment schedules, or will be paid when funds are appropriated. Of the total long-term obligations outstanding, 93% will be paid by the General Fund and 7% by special revenue funds. The changes in the General Long-Term Obligations Account Group during the year ended June 30, 1997, are summarized in Table 10.

**Table 10**

**Schedule of Changes in General Long-Term Obligations**
(Amounts in thousands)

| | Balance July 1, 1996 | Additions | Deductions | Balance June 30, 1997 |
|---|---|---|---|---|
| Compensated absences payable | $ 1,156,073 | $ 590,661 | $ 680,243 | $ 1,066,491 |
| Certificates of participation and commercial paper | 260,395 | 1,505,480 | 862,125 | 903,750 |
| Capital lease obligations | 2,993,592 | 113,089 | 142,396 | 2,964,285 |
| General obligation bonds payable | 14,224,172 | 1,026,144 | 1,041,885 | 14,208,431 |
| Revenue bonds payable | 239,395 | 340,555 | 10,425 | 569,525 |
| Other liabilities | 1,597,566 | 851,954 | 795,614 | 1,653,906 |
| **Totals** | **$ 20,471,193** | **$ 4,427,883** | **$ 3,532,688** | **$ 21,366,388** |

## NOTE 9. COMPENSATED ABSENCES

As of June 30, the estimated liability for compensated absences related to accumulated vacation and annual leave totaled approximately $1.6 billion. Of this amount, $1.1 billion is reported in the General Long-Term Obligations Account Group, $62 million is reported in the proprietary fund types, $115 million is reported in the General Fund, and $312 million is reported for the discretely presented component units.

## NOTE 10. CERTIFICATES OF PARTICIPATION

Debt service requirements for certificates of participation, which are financed by lease payments from the General Fund, are shown in Table 11.

**Table 11**

**Schedule of Debt Service Requirements for Certificates of Participation – Primary Government**
(Amounts in thousands)

| Year Ending June 30 | Principal | Interest | Total |
|---|---|---|---|
| 1998 | $ 9,090 | $ 5,187 | $ 14,277 |
| 1999 | 7,453 | 6,814 | 14,267 |
| 2000 | 7,315 | 7,248 | 14,563 |
| 2001 | 7,434 | 6,779 | 14,213 |
| 2002 | 7,180 | 7,023 | 14,203 |
| Thereafter | 84,458 | 75,077 | 159,535 |
| **Total** | **$ 122,930** | **$ 108,128** | **$ 231,058** |

Debt service requirements for certificates of participation for the University of California, a discretely presented component unit, are shown in Table 12.

**Table 12**

**Schedule of Debt Service Requirements for Certificates of Participation – University of California – Discretely Presented Component Unit**
(Amounts in thousands)

| Year Ending June 30 | Principal | Interest | Total |
|---|---|---|---|
| 1998 | $ 7,605 | $ 13,953 | $ 21,558 |
| 1999 | 8,125 | 13,435 | 21,560 |
| 2000 | 8,615 | 12,804 | 21,419 |
| 2001 | 9,310 | 12,234 | 21,544 |
| 2002 | 7,645 | 11,806 | 19,451 |
| Thereafter | 206,590 | 122,485 | 329,075 |
| Total | $ 247,890 | $ 186,717 | $ 434,607 |

**Current Year Defeasance:** On March 26, 1997, Refunding Certificates (the Refunding 1997 Certificates) of approximately $22 million were executed and delivered pursuant to a Trust Agreement among the Department of General Services, the Franchise Tax Board, and the Bank of New York Western Trust Company of California. The Refunding 1997 Certificates were issued to advance refund approximately $21 million of outstanding 1989 Certificates. The net proceeds of approximately $22 million (after payment of approximately $318,000 in underwriting fees and other issuance costs) together with other available funds of approximately $700,000 were deposited in an escrow fund and held by the Bank of New York Western Trust Company of California to provide for all future debt service payments on the refunded certificates. As a result, the refunded 1989 Certificates are considered to be defeased and the liability for those certificates has been removed from the financial statements, as well as the related investments. The Department of General Services advance refunded the 1989 Certificates to reduce its total debt service payments over the next 10 years by approximately $1 million and to obtain an economic gain (the difference between the present values of the debt service payments of the old and new debt) of approximately $853,000.

## NOTE 11. COMMERCIAL PAPER AND OTHER BORROWINGS

The primary government has two commercial paper borrowing programs: a general obligation commercial paper program of up to $1.0 billion and an enterprise fund commercial paper program for the Department of Water Resources of up to $150 million. The general obligation commercial paper program was increased to $1.8 billion on July 15, 1997. Under these programs, commercial paper may be issued at prevailing interest rates for periods of not more than 270 days from the date of issuance. To provide liquidity for the programs, a revolving credit agreement has been entered into wit commercial banks equal to the authorized amount of commercial paper. As of June 30, 1997, there were borrowings of approximately $781 million of general obligation commercial paper and $60 million of enterprise fund commercial paper outstanding. The proceeds from the issuance of commercial paper are restricted primarily to the construction costs of general obligation bond program projects and of certain water projects. Because the general obligation commercial paper is retired by long-term general obligation debt, it is recorded in the General Long-Term Obligations Account Group.

The University of California, a discretely presented component unit, has mortgages and other borrowings, consisting of contractual obligations resulting from the acquisition of land or buildings and the construction and renovation of certain facilities. The mortgages are secured by real property. Included in mortgages and other borrowings, which total approximately $347 million, are various unsecured financing agreements with commercial banks that total approximately $164 million.

In October 1996, the University of California established a $550 million commercial paper program with tax-exempt and taxable components. The program is supported by a revolving line of credit and term loan agreement with a syndicate of banking institutions. Commercial paper has been issued to provide for interim financing of construction and related equipment and medical center working capital requirements. Commercial paper is not secured by any encumbrance, mortgage, or other pledge of property and does not constitute a general obligation of the University of California Regents. At June 30, 1997, outstanding tax-exempt and taxable commercial paper was $340 million and $210 million, respectively. Approximately $111 million of the proceeds were applied to repay outstanding bank loans.

## NOTE 12. LEASES

The aggregate amount of lease commitments for facilities and equipment of the primary government in effect as of June 30, is approximately $6.2 billion. This amount does not include any future escalation charges for real estate taxes and operating expenses. Most primary government leases are classified as operating leases, in accordance with the applicable standards, and contain clauses providing for termination. It is expected that in the normal course of business most of these operating leases will be replaced by similar leases.

The total present value of minimum lease payments for the primary government is composed of approximately $3.0 billion in the General Long-Term Obligations Account Group and $30 million internal service funds. Lease expenditures for the year ended June 30 amounted to approximately $580 million.

Included in the capital lease commitments are lease-purchase agreements that certain state agencies have entered into with the State Public Works Board, an enterprise fund agency, amounting to a present value of net minimum lease payments of $2.8 billion. This amount represents 95% of the total present value of minimum lease payments of the primary government. Also included in the capital lease commitments are some lease-purchase agreements to acquire electronic data processing and other equipment.

The capital lease commitments do not include $312 million of lease-purchase agreements with building authorities that are blended component units. These building authorities acquire or develop office buildings and then lease the facilities to state agencies. Upon expiration of the leases, title will pass to the primary government. The costs of the buildings are reported in the General Fixed Assets Account Group and the revenue bonds and certificates of participation outstanding associated with the buildings are reported in the General Long-Term Obligations Account Group. Accordingly, the lease receivables or capital lease obligations associated with these buildings are not included in the financial statements pursuant to GASB Statement No. 14.

Future minimum lease commitments of the primary government are summarized in Table 13.

**Table 13**

**Schedule of Future Minimum Lease Commitments – Primary Government**
(Amounts in thousands)

| Year Ending June 30 | Operating Leases | Capital Leases: General Long–Term Obligations | Capital Leases: Internal Service Funds | Total |
|---|---|---|---|---|
| 1998 | $ 205,174 | $ 341,382 | $ 4,547 | $ 551,103 |
| 1999 | 157,312 | 332,370 | 4,549 | 494,231 |
| 2000 | 94,450 | 330,716 | 4,547 | 429,713 |
| 2001 | 63,515 | 316,207 | 4,547 | 384,269 |
| 2002 | 44,908 | 311,937 | 4,576 | 361,421 |
| Thereafter | 63,680 | 3,858,966 | 16,243 | 3,938,889 |
| **Total Minimum Lease Payments** | **$ 629,039** | **5,491,578** | **39,009** | **$ 6,159,626** |
| Less amount representing interest | | 2,527,293 | 8,747 | |
| **Present Value of Net Minimum Lease Payments** | | **$ 2,964,285** | **$ 30,262** | |

The aggregate amount of discretely presented component units lease commitments for land, facilities, and equipment in effect as of June 30, 1997, is approximately $2.3 billion. Table 14 presents the future minimum lease commitments for the University of California and the special purpose authorities, as of June 30. Operating lease expenditures for the year ended June 30 amounted to approximately $118.3 million for discretely presented component units.

**Table 14**

**Schedule of Future Minimum Lease Commitments – Discretely Presented Component Units**
(Amounts in thousands)

| Year Ending June 30 | University of California Capital | University of California Operating | Special Purpose Authorities Operating | Total |
|---|---|---|---|---|
| 1998 | $ 200,062 | $ 54,126 | $ 16,450 | $ 270,638 |
| 1999 | 113,190 | 37,165 | 12,439 | 162,794 |
| 2000 | 105,079 | 28,728 | 8,717 | 142,524 |
| 2001 | 99,860 | 23,577 | 6,716 | 130,153 |
| 2002 | 94,484 | 17,449 | 3,019 | 114,952 |
| Thereafter | 1,416,552 | 84,871 | 2,783 | 1,504,206 |
| **Total Minimum Lease Payments** | 2,029,227 | $ 245,916 | $ 50,124 | $ 2,325,267 |
| Less amount representing interest | 799,894 | | | |
| **Present Value of Net Minimum Lease Payments** | $ 1,229,333 | | | |

## NOTE 13. COMMITMENTS

The primary government has made commitments of $2.8 billion for certain highway construction projects. These commitments are not included in the reserve for encumbrances in the special revenue funds because the future expenditures related to these commitments are expected to be reimbursed from local governments and proceeds of approved federal grants. The ultimate liability will not accrue to the State.

As of June 30, the primary government had other commitments totaling $2.5 billion that are not included as a liability on the balance sheet. These commitments, which included loan and grant programs for housing, school building aid, rail system, and county jail construction, total approximately $1.4 billion. The total commitments also include approximately $29 million for the rehabilitation of toll bridge facilities, approximately $835 million for the construction of water projects and the purchase of power, and up to $204 million for the operation and maintenance of the lottery's automated gaming system. The commitments are expected to be funded from existing program resources and from the proceeds of revenue and general obligation bonds to be issued.

As of June 30, the University of California, a discretely presented component unit, had authorized construction projects totaling $977 million. Special purpose authorities, which are discretely presented component units, had outstanding commitments to provide $384 million for loans under various housing revenue bond programs.

## NOTE 14. GENERAL OBLIGATION BONDS

The State Constitution permits the primary government to issue general obligation bonds for specific purposes and in such amounts as approved by a two-thirds majority of both houses of the Legislature and by a majority of voters in a general or direct primary election. The debt service for general obligation bonds is appropriated from the General Fund. Under the State Constitution, the General Fund is used, first, to support the public school system and public institutions of higher education. The General Fund can then be used to service the debt on outstanding general obligation bonds. Enterprise funds and certain other funds reimburse the General Fund for any debt service provided on their behalf.

General obligation bonds that are directly related to, and expected to be paid from, the resources of enterprise funds are included within the accounts of such funds in the financial statements. However, the General Fund may be liable for the payment of any principal and interest on these bonds that is not met from the resources of such funds.

As of June 30, $7.5 billion of general obligation bonds had been authorized but not issued. This amount includes $3.6 billion that has been authorized by the applicable finance committee for future issuance in the form of commercial paper notes. The $7.5 billion excludes $781 million in general obligation indebtedness that has been issued in the form of commercial paper notes, but has not yet been retired by long-term bonds.

Table 15 summarizes the changes in general obligation bond debt for the year ended June 30.

**Table 15**

**Schedule of Changes in General Obligation Bond Debt**
(Amounts in thousands)

| | General Long-Term Obligations | Enterprise Funds | Total |
|---|---|---|---|
| Balance July 1, 1996 | $ 14,224,172 | $ 3,982,285 | $ 18,206,457 |
| Additions | 1,026,144 | — | 1,026,144 |
| Deductions | (1,041,885) | (236,690) | (1,278,575) |
| **Balance June 30, 1997** | **$ 14,208,431** | **$ 3,745,595** | **$ 17,954,026** |

Table 16 shows the debt service requirements for all general obligation bonds, including interest of $10.5 billion, as of June 30, 1997.

**Table 16**

**Schedule of General Obligation Bonds Debt Service Requirements**
(Amounts in thousands)

| Year Ending June 30 | General Long-Term Obligations | Enterprise Funds |
|---|---|---|
| 1998 | $ 1,852,935 | $ 447,482 |
| 1999 | 1,769,051 | 431,790 |
| 2000 | 1,698,051 | 436,017 |
| 2001 | 1,638,071 | 430,803 |
| 2002 | 1,592,105 | 441,802 |
| Thereafter | 13,729,903 | 4,020,411 |
| Total | $ 22,280,116 | $ 6,208,305 |

**Current Year Defeasances:** The primary government did not have refundings of general obligation bonds for the year ended June 30, 1997.

**Prior Year Defeasances:** In prior years, the primary government has defeased certain bonds by placing the proceeds of new bonds in irrevocable escrow in a special trust account with the State Treasury to provide for all future debt service payments on the old bonds. Accordingly, the assets of the trust accounts and the liability for the defeased bonds are not included in the State's financial statements. At June 30, 1997, approximately $269 million of general obligation bonds outstanding are considered defeased.

## NOTE 15. REVENUE BONDS

Revenue bonds that are directly related to and expected to be paid from the resources of enterprise funds are included within the accounts of such funds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds of the authorities and agencies listed in the next section of this note. The General Fund has no legal liability for payment of principal and interest on revenue bonds.

Revenue bonds to acquire, construct, or renovate state facilities or to refund outstanding revenue bonds in advance are issued for Water Resources, Toll Facilities, California State University, and Leasing of Public Assets. Revenue bonds are also issued to make loans to finance the acquisition of farms and homes by California veterans. When the farm and home loans financed by the revenue bonds are fully paid, the farms and homes become the property of private individuals.

Certain building authorities, under state law, may issue revenue bonds. These revenue bonds are included in the General Long-Ter Obligations Account Group. These bonds are issued for the purpos of acquiring and constructing buildings for public education purposes and for the purpose of constructing state office buildings. Leases with state agencies pay the principal and interest on the revenue bonds issued by the building authorities. The primary government has no legal liability for the payment of principal and interest on these revenue bonds.

The University of California, a discretely presented component unit, issues revenue bonds to finance the construction, renovation, and acquisition of certain facilities and equipment.

Under state law, a special purpose authority, which is a discretely presented component unit, issues revenue bonds to make loans to finance housing developments and to finance the acquisition of homes by low to moderate income families. When the housing developments and home loans are fully paid, the housing developments and homes become the property of private individuals or entities.

Table 17 shows revenue bonds outstanding as of June 30.

**Table 17**

**Schedule of Revenue Bonds Outstanding**
June 30, 1997
(Amounts in thousands)

| | |
|---|---|
| **Primary Government** | |
| **Enterprise Funds** | |
| Housing Loan | $ 327,580 |
| Water Resources | 2,329,379 |
| Toll Facilities | 50,405 |
| California State University | 485,703 |
| Leasing of Public Assets | 5,353,971 |
| **Total Enterprise Funds** | **8,547,038** |
| **General Long-Term Obligations** | |
| Building Authorities | 569,525 |
| **Total General Long–Term Obligations** | **569,525** |
| **Total Primary Government** | **9,116,563** |
| **Discretely Presented Component Units** | |
| University of California | 2,187,675 |
| Special Purpose Authorities | 5,168,007 |
| **Total Discretely Presented Component Units** | **7,355,682** |
| **Total** | **$ 16,472,245** |

Table 18 shows the debt service requirements as of June 30, 1997. The debt service requirements primarily represent bond principal payments. Table 18 also includes certain unamortized refunding costs, premiums, discounts, and other costs not included in Table 17.

**Table 18**

**Schedule of Revenue Bond Debt Service Requirements**
(Amounts in thousands)

| Year Ending June 30 | Primary Government: General Long-Term Obligations | Primary Government: Enterprise Funds | Discretely Presented Component Units |
|---|---|---|---|
| 1998 | $ 40,560 | $ 298,069 | $ 233,806 |
| 1999 | 40,582 | 332,208 | 254,811 |
| 2000 | 48,470 | 342,869 | 264,646 |
| 2001 | 48,479 | 359,654 | 275,515 |
| 2002 | 48,100 | 342,635 | 281,456 |
| Thereafter | 731,469 | 7,226,638 | 7,917,894 |
| Total | $ 957,660 | $ 8,902,073 | $ 9,228,128 |

**Current Year Defeasances:** In November 1996, the primary government issued approximately $267 million in Central Valley Project (CVP) revenue bonds, a portion of which was used to advance refund approximately $102 million of outstanding revenue bonds. In March 1997, the primary government issued approximately $21 million CVP revenue bonds to advance refund approximately $18 million of outstanding revenue bonds. The net proceeds of approximately $127 million (after payment of approximately $1 million in underwriting fees, insurance, and other issuance costs) were used to purchase securities that were deposited in an irrevocable trust with the State Treasurer to provide for all future debt service payments on the refunded bonds. As a result, the refunded bonds are considered defeased and the liability for those bonds and the related investments have been removed from the financial statements. The primary government advance refunded the bonds to reduce its total debt service payments over the next 30 years by approximately $12 million and to obtain an economic gain (the difference between the present values of the debt service payments on the old and new debt) of approximately $5 million.

On December 1, 1996, the primary government issued approximately $10 million in California State University Fullerton Student Union Revenue Bonds to advance refund approximately $9 million of outstanding Fullerton Student Union Series B bonds. The net proceeds of approximately $9 million (after payment of approximately $94,000 in underwriting fees, insurance, and other issuance costs) were used to purchase U.S. Government securities that were deposited in an irrevocable trust with the State Treasurer to provide for all future debt service payments on the refunded bonds. As a result, the Series B bonds are considered to be defeased and the liability for those bonds and the related investments have been removed from the financial statements. The primary government advance refunded the Series B bonds to reduce its total debt service payments over the next 24 years by approximat

$819,000 and to obtain an economic gain (the difference between the present values of the debt service payments on the old and new debt) of approximately $409,000.

For the year ended June 30, 1997, the primary government issued approximately $819 million in revenue bonds for Leasing of Public Assets to advance refund approximately $740 million of various outstanding revenue bonds. The net proceeds of approximately $794 million (after payment of approximately $25 million in underwriting fees, insurance, and other issuance costs) together with other available monies of $10 million were deposited in an irrevocable trust with the State Treasurer to provide for all future debt service payments on the various refunded bonds. As a result, the refunded bonds are considered to be defeased and the liability for those bonds and the related investments have been removed from the financial statements. The primary government advance refunded the various bonds to reduce its total debt service payments over the next 22 years by approximately $47 million and to obtain an economic gain (the difference between the present value of the debt service payments on the old and new debt) of approximately $27 million.

**Prior Year Defeasances:** In prior years, the primary government defeased certain bonds by placing the proceeds of new bonds in an irrevocable trust account to provide for all future debt service payments on the old bonds. Accordingly, the assets and liabilities for the defeased bonds are not included in the financial statements. As of June 30, 1997, $1.4 billion of revenue bonds outstanding are considered defeased.

In prior years, the University of California and the special purpose authorities, which are discretely presented component units, defeased certain bonds. As of June 30, 1997, $722 million of University of California revenue bonds outstanding are considered defeased. The special purpose authorities did not have any revenue bonds outstanding that are considered defeased.

## NOTE 16. MAJOR TAX REVENUES

Tax revenues for the year ended June 30, are presented in Table 19.

**Table 19**

**Schedule of Major Tax Revenues**
Year Ended June 30, 1997
(Amounts in thousands)

| | General Fund | Special Revenue Funds | Expendable Trust Funds |
|---|---|---|---|
| Personal income | $ 23,176,711 | $ — | $ — |
| Sales and use | 16,566,172 | 3,600,499 | — |
| Bank and corporation | 5,674,049 | — | — |
| Unemployment insurance | — | — | 3,264,671 |
| Disability insurance | — | — | 1,391,939 |
| Insurance | 1,210,438 | — | — |
| Inheritance, estate, and gift | 724,762 | — | — |
| Cigarette and tobacco | 168,288 | 498,163 | — |
| Other | 304,304 | 223,925 | 39,998 |
| **Total** | **$ 47,824,724** | **$ 4,322,587** | **$ 4,696,608** |

## NOTE 17. FUND EQUITY

### A. Fund Deficits

The following funds had deficits at June 30, as shown in Table 20.

**Table 20**

**Schedule of Fund Deficits - Primary Government**
June 30, 1997
(Amounts in thousands)

| | General Fund | Special Revenue Funds | Capital Projects Funds | Internal Service Funds |
|---|---|---|---|---|
| Financing to Locals | $ — | $ 17,214 | $ — | $ — |
| Higher Education Construction | — | — | 7,954 | — |
| Other Capital Projects | — | — | 684 | — |
| Water Resources Revolving | — | — | — | 11,942 |
| Architecture Revolving | — | — | — | 7,445 |
| **Total** | **$ 2,476,891** | **$ 17,214** | **$ 8,638** | **$ 19,387** |

### B. Changes to Contributed Capital

The changes in the State's contributed capital accounts for its proprietary funds are shown in Table 21.

**Table 21**

**Schedule of Changes in Contributed Capital**
(Amounts in thousands)

| Sources | Enterprise | Internal Service | Total |
|---|---|---|---|
| Balance, July 1, 1996 | $ 216,247 | $ 112,239 | $ 328,486 |
| Government contributions | — | 87 | 87 |
| **Balance, June 30, 1997** | **$ 216,247** | **$ 112,326** | **$ 328,573** |

## NOTE 18. RISK MANAGEMENT

The primary government has elected, with a few exceptions, to be self-insured against loss or liability. Generally, the exceptions are when a bond resolution or a contract requires the primary government to purchase commercial insurance for coverage against property loss or liability. There have been no significant reductions in insurance coverage from the prior year. In addition, there has been no insurance settlement in the last three years that has exceeded insurance coverage. The primary government generally does not maintain reserves. Losses are covered by appropriations from each fund responsible for payment in the year in which the payment occurs. All claim payments are on a "pay as you go" basis. The potential amount of loss arising from risks other than workers' compensation benefits are not considered material in relation to the primary government's financial position.

Workers' compensation benefits for self-insured agencies are initially paid by the SCIF. The liability for future workers' compensation claims against the primary government's self-insured agencies is estimated to be approximately $869 million as of June 30. The liability represents the estimated total cost of all open and known disability claims as of June 30 including claims incurred but not reported. The estimates are based on established claims criteria such as age of the injured, occupation, and type of injury. Of the total, $106 million is included in the General Fund, $69 million in the special revenue fund type, $22 million in the proprietary fund types, and $672 million in the General Long-Term Obligations Account Group. Changes in the claims liabilities during year ended June 30 are shown in Table 22.

The University of California, a discretely presented component unit, is self-insured for medical malpractice, workers' compensation, employee health care, and general liability claims. These risks are subject to various claim and aggregate limits, with excess liability coverage provided by an independent insurer. Liabilities are recorded when it is probable a loss has occurred and the amount of the loss can be reasonably estimated. These losses include an estimate for claims that have been incurred but not reported. The estimated liabilities are based upon an independent actuarial determination of the anticipated future payments discounted at rates ranging from 6.5 percent to 8.0 percent. The special purpose authorities, which are discretely presented component units, do not have any significant liabilities related to self insurance.

**Table 22**

**Schedule of Changes in the Self Insurance Claims**
Years Ended June 30
(Amounts in thousands)

| | Primary Government | | University of California – Discretely Presented Component Unit | |
|---|---|---|---|---|
| | 1997 | 1996 | 1997 | 1996 |
| Unpaid claims, beginning | $ 733,000 | $ 753,000 | $ 368,000 | $ 358,800 |
| Incurred claims | 341,000 | 170,000 | 127,900 | 200,300 |
| Claim payments | (205,000) | (190,000) | (171,100) | (191,100) |
| **Unpaid claims, ending** | **$ 869,000** | **$ 733,000** | **$ 324,800** | **$ 368,000** |

## NOTE 19. SEGMENT INFORMATION

Selected financial information by enterprise fund activity for major segments is shown in Table 23. The primary sources of enterprise fund revenues are as follows.

**Housing Loan:** Interest charged on contracts of sale of properties to California veterans and to California National Guard members; loan origination fees; and interest on investments.
**Water Resources:** Charges to local water districts, sale of excess power to public utilities, and interest earned on investments.
**School Building Aid:** Interest charged on loans to school districts for acquisition, construction, or rehabilitation of classroom facilities; and income from the rental of portable classrooms to school districts.
**Toll Facilities:** Toll fees and interest earned on investments.
**California State University:** Charges to students for housing and parking; student fees for campus unions, health centers, and self-supporting educational programs; and interest earned on investments.
**Leasing of Public Assets:** Rental charges from the lease of public assets and interest earned on investments.
**State Lottery:** Sale of lottery tickets.
**Harbors and Watercraft:** Fees related to boating activities.
**Health Facilities Construction Loan Insurance:** Construction project fees and income from operations or proceeds of sales of property acquired by default of borrowers.
**Other Enterprise:** Canteen revenues and fees charged by various other departments.

## Table 23

**Schedule of Enterprise Fund Activity by Separate Major Segments**
As of and for the Year Ended June 30, 1997
(Amounts in thousands)

| | Housing Loan | Water Resources | School Building Aid | Toll Facilities | California State University | Leasing of Public Assets | State Lottery | Harbors and Watercraft | Health Facilities Construction Loan Insurance | Other Enterprise |
|---|---|---|---|---|---|---|---|---|---|---|
| Operating revenue............ | $ 234,441 | $ 561,578 | $ 24,432 | $ 143,557 | $ 257,815 | $ 373,823 | $ 2,063,135 | $ 6,716 | $ 8,814 | $ 78,640 |
| Depreciation...................... | 716 | 58,733 | 3,720 | 13,867 | — | — | 9,597 | — | — | 13 |
| Amortization of deferred | | | | | | | | | | — |
| charges | — | 61,360 | — | 430 | — | 5,173 | 1,803 | — | — | — |
| Operating income (loss)..... | (20,952) | 180,492 | 14,761 | 86,299 | 67,603 | 34,912 | 711,901 | (28,804) | (26,635) | 4,615 |
| Operating transfers in........ | 12,299 | — | — | 6 | 8,708 | 543,162 | — | 31,574 | — | 7,599 |
| Operating transfers out...... | 10,857 | — | 57,517 | 2,995 | 33,137 | 543,310 | — | — | — | 1,577 |
| Net income (loss).............. | (17,491) | 18,460 | 49,461 | 81,948 | 40,142 | 34,764 | — | 16,318 | (18,887) | 12,019 |
| Grants received................ | — | — | — | — | 389 | — | — | — | — | — |
| Grants provided................ | — | — | — | 34,444 | — | — | — | — | — | — |
| Property, plant, and equipment | | | | | | | | | | |
| Additions...................... | 113 | 174,714 | — | 51,209 | 40,651 | 371,103 | 1,234 | 25 | — | — |
| Deductions.................... | 716 | 58,733 | 3,720 | 13,867 | — | — | 9,627 | — | — | 833 |
| Net working capital........... | 1,155,609 | 78,126 | 15,733 | 710,553 | 458,359 | 490,874 | 2,705,737 | 21,134 | 125,518 | 62,148 |
| **Total assets.....................** | **3,468,309** | **5,026,980** | **383,285** | **1,281,238** | **1,258,836** | **5,656,761** | **2,971,494** | **313,424** | **136,260** | **150,780** |
| Bonds and other long term liabilities........ | 3,112,968 | 3,427,201 | 7,500 | 56,565 | 495,842 | 5,353,971 | 2,762,065 | 388 | 190 | 52,745 |
| **Total equity......................** | **272,438** | **1,110,830** | **317,692** | **1,197,504** | **680,025** | **150,148** | **—** | **222,377** | **125,336** | **65,588** |

## NOTE 20. CONDENSED FINANCIAL STATEMENTS - DISCRETELY PRESENTED COMPONENT UNITS

Tables 24 and 25 present summary financial statements of the special purpose authorities which are the SCIF, the CHFA, and Non-Major Component Units. The financial statements of the University of California, a discretely presented component unit, are presented separately in the combined statements of this report.

The SCIF is a component unit created to offer insurance protection to employers at the lowest possible cost. This information is as of and for the year ended December 31, 1996. The CHFA was created for the purpose of meeting the housing needs of persons and families of low and moderate income. The Non-Major Component Units provide certain services that are not part of the primary government and also provide certain private and public entities with a low-cost source of financing for activities that are deemed to be in the public interest.

## Table 24

**Condensed Balance Sheet – Special Purpose Authorities–Discretely Presented Component Units**
June 30, 1997
(Amounts in thousands)

| | State Compensation Insurance | California Housing Finance Agency | Non-Major Component Units | Total |
|---|---|---|---|---|
| **Assets** | | | | |
| Due from primary government | $ — | $ — | $ 3,454 | $ 3,454 |
| Due from other funds | — | — | 549 | 549 |
| Other current assets | 1,275,326 | 372,156 | 145,868 | 1,793,350 |
| Investments | 5,673,333 | 1,200,611 | 40,610 | 6,914,554 |
| Advances and loans receivable | — | 4,360,172 | — | 4,360,172 |
| Fixed assets | 232,127 | — | 342,099 | 574,226 |
| **Total Assets** | **$ 7,180,786** | **$ 5,932,939** | **$ 532,580** | **$ 13,646,305** |
| **Liabilities** | | | | |
| Other current liabilities | $ 1,015,911 | $ 323,945 | $ 24,899 | $ 1,364,755 |
| Benefits payable | 4,521,682 | — | — | 4,521,682 |
| Revenue bonds payable | — | 5,089,304 | 78,703 | 5,168,007 |
| Contracts and notes payable | — | — | 3,928 | 3,928 |
| **Total Liabilities** | **5,537,593** | **5,413,249** | **107,530** | **11,058,372** |
| **Fund Equity** | | | | |
| Contributed capital | — | — | 99 | 99 |
| Retained earnings | | | | |
| Reserved for regulatory requirements | 100,000 | 464,546 | — | 564,546 |
| Unreserved | 1,543,193 | 55,144 | 424,951 | 2,023,288 |
| **Total Fund Equity** | **1,643,193** | **519,690** | **425,050** | **2,587,933** |
| **Total Liabilities and Fund Equity** | **$ 7,180,786** | **$ 5,932,939** | **$ 532,580** | **$ 13,646,305** |

**Table 25**

**Condensed Statement of Revenues, Expenses, and Changes in Retained Earnings – Special Purpose Authorities – Discretely Presented Component Units**

Year Ended June 30, 1997
(Amounts in thousands)

| | State Compensation Insurance | California Housing Finance Agency | Non-Major Component Units | Total |
|---|---|---|---|---|
| **Operating Revenues** | | | | |
| Earned premiums (net) | $ 992,197 | $ — | $ — | $ 992,197 |
| Other revenue | — | 331,153 | 150,464 | 481,617 |
| **Total Operating Revenues** | 992,197 | 331,153 | 150,464 | 1,473,814 |
| **Operating Expenses** | | | | |
| Depreciation | 11,424 | 356 | 3,470 | 15,250 |
| Benefit payments | 1,088,349 | — | — | 1,088,349 |
| Interest expense | — | 309,485 | — | 309,485 |
| Amortization of deferred charges | — | 1,707 | — | 1,707 |
| Other operating expenses | 197,121 | 42,604 | 111,858 | 351,583 |
| **Total Operating Expenses** | 1,296,894 | 354,152 | 115,328 | 1,766,374 |
| **Operating Income (Loss)** | (304,697) | (22,999) | 35,136 | (292,560) |
| **Nonoperating Revenues (Expenses)** | | | | |
| Interest revenue | 470,703 | 81,202 | 1,620 | 553,525 |
| Dividends paid | (117,069) | — | — | (117,069) |
| Other nonoperating revenues (expenses) | — | — | (5,182) | (5,182) |
| **Net Nonoperating Revenues (Expenses)** | 353,634 | 81,202 | (3,562) | 431,274 |
| **Net Income** | 48,937 | 58,203 | 31,574 | 138,714 |
| **Retained Earnings, July 1, 1996** | 1,594,256 | 461,487 | 393,377 | 2,449,120 |
| **Retained Earnings, June 30, 1997** | $ 1,643,193 | $ 519,690 | $ 424,951 | $ 2,587,834 |

## NOTE 21. NO COMMITMENT DEBT

Certain debt of the special purpose authorities, which are discretely presented component units, is collateralized solely by the credit of private and public entities and is administered by trustees independent of the State or by the State Treasurer's Office. As of June 30, the special purpose authorities had $10.7 billion of debt outstanding, which is not debt of the State.

## NOTE 22. CONTINGENT LIABILITIES

### A. Litigation

The primary government is a party to numerous legal proceedings, many of which normally occur in governmental operations. The following were accrued as a liability in the financial statements: legal proceedings that were decided against the primary government before June 30, 1997; legal proceedings that were in progress as of June 30, 1997, and were settled or decided against the primary government as of November 21, 1997; and legal proceedings having a high probability of resulting in a decision against the primary government as of November 21,1997, and for which amounts could be estimated. For governmental fund types and expendable trust funds, the portion of the liability that is expected to be paid within the next 12 months is recorded as a liability of the fund from which payment will be made; the remainder is shown as a liability of the General Long-Term Obligations Account Group. For other fund types, the entire liability is recorded in the fund involved. In addition, the primary government is involved in certain other legal proceedings that, if decided against the primary government, may require the primary government to make significant future expenditures or may impair future revenue sources. Because of the prospective nature of these proceedings, no provision for this potential liability has been made in the financial statements.

Following are the more significant lawsuits pending against the primary government:

Northern California 1997 Flood Litigation: In January of 1997, California experienced major flooding in six different areas with current estimates of property damage to be approximately $1.6 to $2 billion. To date, one lawsuit has been filed by 500 homeowners, but more lawsuits are expected. Exposure from all of the anticipated cases arising from these floods could total approximately $2 billion.

The primary government is a defendant in several related cases, mainly *California Ambulance Association v. Shalala et al.*, in which the plaintiffs are seeking action to compel the Department of Health Services to pay Part B ambulance and physician services co-payments under the Medicare and Medicaid Acts. Should the plaintiffs prevail, the liability for retroactive payments is estimated to be $490 million, and the liability for future payments can be in excess of $130 million annually. The General Fund and the federal government will share the liability equally.

The primary government is a defendant in *Ceridian Corporation v. Franchise Tax Board*, a suit which challenges the validity of two sections of the California Tax laws. The first relates to deduction from corporate taxes for dividends received from insurance companies to the extent the insurance companies have California activities. The second relates to corporate deduction of dividends to the extent the earnings of the dividend paying corporation have already been included in the measure of their California tax. If both sections of the California Tax law are invalidated, and all dividends become deductible, then the General fund can become liable for approximately $200-$250 million annually.

The primary government is involved in a lawsuit, *Thomas Hayes v. Commission on State Mandates*, related to state-mandated costs. The action involves an appeal by the Director of Finance from a 1984 decision by the State Board of Control (now succeeded by the Commission on State Mandates (COSM)). The Board of Control decided in favor of local school districts' claims for reimbursement for special education programs for handicapped students. The case was then brought to the trial court by the primary government and later remanded to the COSM for redetermination. The COSM has since expanded the claim to include supplemental claims filed by seven other educational institutions; the issuance of a final consolidated decision is anticipated sometime in early 1998. To date, the Legislature has not appropriated funds. The liability to the primary government, if all potentially eligible school districts pursue timely claims, has been estimated by the Department of Finance at more than $1 billion.

The primary government is involved in a lawsuit related to contamination at the Stringfellow toxic waste site. In *United States, People of the State of California v. J. B. Stringfellow, Jr., et al.*, the primary government is seeking recovery for past costs of cleanup of the site, a declaration that the defendants are jointly and severally liable for future costs, and an injunction ordering completion of the cleanup. However, the defendants have filed a counterclaim against the primary government for alleged negligent acts. Because the primary government is the present owner of the site, the primary government may be found liable. Present estimates of the cleanup range from $300 million to $800 million.

The primary government is a defendant in a coordinated action involving 3,000 plaintiffs seeking recovery for damages caused by the Yuba River flood of February 1986. The trial court has found liability in inverse condemnation and awarded damages of $500,000 to a sample of plaintiffs. The primary government's potential liability to the remaining plaintiffs ranges from $800 million to $1.5 billion. An appeal has been filed.

The primary government is a defendant in *California State Employees Association v. Wilson*, where the petitioners are challenging several budget appropriations in the 1994 and 1995 Budget Acts. The appropriations mandate the transfer of funds from the State Highway Account, within the special revenue funds, to the General Fund to reimburse the General Fund for debt service costs on two rail bond measures. The petitioners contend that the transfers violate the bond acts themselves and are requesting the monies be returned. The loss to the primary government's General Fund could be up to $227 million.

In a similar case, *Professional Engineers in California Government v. Wilson*, the petitioners are challenging several appropriations in the 1993, 1994, and 1995 Budget Acts. The appropriations mandate the transfer of approximately $262 million from the State Highway Account, within the special revenue funds, and $113 million from the Motor Vehicle Account, within the special revenue funds, to the General Fund and appropriate approximately $6 million from the State Highway Account to fund a highway-grade crossing program administered by the Public Utilities Commission. Petitioners contend that the transfers violate several constitutional provisions and request that the moneys be returned to the State Highway Account and Motor Vehicle Account.

The primary government is a defendant in *Just Say No To Tobacco Dough Campaign v. State of California*, where the petitioners challenge the appropriation of approximately $166 million of Proposition 99 funds in the Cigarette and Tobacco Products Surtax Fund for years ended June 30, 1990, through June 30, 1995, for programs which were allegedly not health education or tobacco-related disease research. If the primary government loses, the General Fund and funds from other sources would be used to reimburse the Cigarette and Tobacco Products Surtax Fund, an agency fund, for approximately $166 million.

The primary government is a defendant in the case of *Kurt Hathaway, et al. v. Wilson, et al.*, where the plaintiffs are challenging the legality of various budget action transfers and appropriations from particular special funds for years ended June 30, 1995, and June 30, 1996. The plaintiffs allege that the transfers and appropriations are contrary to the substantive law establishing the funds and providing for interest accruals to the fund, violate the single subject requirement of the State Constitution, and is an invalid "special law". Plaintiffs seek to have monies totaling approximately $335 million returned to the special funds.

The primary government is a defendant in two related cases, *Beno vs. Sullivan* (Beno) and *Welch vs. Anderson* (Welch), concerning reductions in Aid to Families with Dependent Children (AFDC) grant payments. In the Beno case, plaintiffs seek to invalidate AFDC grant reductions, and in the Welch case plaintiffs contend that AFDC grant reductions are not authorized by state law. The Beno case concerns the total grant reductions while the Welch case concerns the period of time the State did not have a waiver for those reductions. The primary government's potential liability for retroactive AFDC grant reductions is estimated at $831 million if the plaintiffs are awarded the full amount in both cases.

The University of California and the special purpose authorities, which are discretely presented component units, are contingently liable in connection with claims and contracts, including those currently in litigation, arising in the normal course of their activities. The outcome of such matters are not expected to have a material effect on the financial statements.

**B. Federal Audit Exceptions**

The primary government receives substantial funding from the federal government in the form of grants and contracts. The primary government is entitled to these resources only if it complies with the terms and conditions of the grants and contracts and with the applicable federal laws and regulations; the primary government may spend these resources only for eligible purposes. If audits disclose exceptions, the primary government may incur a liability to the federal government.

## NOTE 23. DEFERRED COMPENSATION PLANS

The primary government administers a long-term tax deferred savings program designed to supplement the retirement income of employees of the primary government, certain special purpose authorities, which are discretely presented component units, and local school districts. The special purpose authorities do not have a significant number of employees enrolled in the program. The program is comprised of a deferred compensation plan (457), a thrift plan (401(k)), and a tax sheltered annuity plan for teachers (403(b)), in accordance with Sections 457, 401(k), and 403(b) of the Internal Revenue Code. In addition, the program includes a mandatory retirement plan for employees covered by neither the California Public Employees' Retirement System (CalPERS) nor Social Security, called the Part-Time, Seasonal and Temporary Plan (PST).

The 457 and 401(k) plans are optional plans for eligible employees. Under these plans, employees defer a portion of their salary on a pre-tax basis. The deferred salary amounts as well as any earnings gained are not taxable to the employees until funds are withdrawn from the plans and received by the employees. Participant withdrawals are subject to various conditions set forth in plan documents. Generally, funds may not be withdrawn, except in cases of emergency, until the participant has retired or separated from civil service, or has reached the required age. Participants of the 457 and 401(k) plans direct the primary government to invest the deferred amounts among various investment options. The primary government makes no contribution to any of these plans and the cost of the program is paid through administrative fees by the program participants. The assets of the 401(k) plan are held for the participants in a trust.

On August 20, 1996, the Small Business Job Protection Act of 1996 was signed into law. Under the new law, assets of the 457 plan are protected from the claims of the employer's creditors. In order to comply with the new law, changes must be implemented to its plan document prior to January 1, 1999. Until such time, the assets held in the 457 plan remain the property of the primary government and continue to be subject to its general creditors.

The 403(b) plan is administered through a third part administrator, State Street Bank. The 403(b) plan is a tax sheltere annuity plan and is open to any employee who is eligible to participate. Contributions to the plan are voluntary and require no minimum limitations. However, the Internal Revenue Code does impose a maximum amount that can be contributed annually. At June 30, 1997, the 403(b) plan had approximately 301 participating employers (school districts) and 1,010 plan members. The 403(b) plan is accounted for as an agency fund.

The PST is a mandatory plan for employees who are not members of the primary government's retirement system and who are not covered by social security. The primary government invests PST participants' deferred amounts into an investment option of the primary government's choosing. The employer makes no contribution to the PST, but the administrative costs to run the PST are paid by the primary government.

The primary government has no liability for losses under the plans but does have the responsibility to administer the plans in good faith. As of June 30, the market value of the four plans was approximately $2.9 billion for the 457, $452 million for the 401(k), $19 million for the 403(b) plan, and $54 million for the PST. The plans are accounted for as agency funds.

The University of California, a discretely presented component unit, has established a tax deferred savings plan in accordance with Section 403(b) of the Internal Revenue Code (UC403(b)). The UC403(b) plan provides savings incentives and additional retirement security for all eligible University employees. There are no employer contributions to the UC403(b) plan. Participants in the UC403(b) plan may direct their elective and nonelective contributions to investment funds managed by the Treasurer of the Regents of the University of California. They may also invest contributions in, and transfer plan accumulations to, certain external mutual funds on a custodial plan basis. The UC403(b) plan after-tax options are generally available to all University employees. During the year ended June 30, participants contributed $200 million into the UC403(b) plan. The UC403(b) plan is accounted within the University of California Retirement System.

## NOTE 24. PENSION TRUSTS

Two retirement systems, the California Public Employees' Retirement System (CalPERS) and the State Teachers' Retirement System (STRS), are included in the primary government. One retirement system, the University of California Retirement System (UCRS), is included in the discretely presented component units. The pension liability, at transition, for all pension trust funds was determined in accordance with GASB Statement No. 27, Accounting for Pensions by State and Local Government Employers. The amounts of the pension liability at transition for all pension trust funds are presented on Tables 27 and 28 as the net pension obligation (NPO) as of June 30, 1997. These amounts also represent the differences between pension liability at transition and the previously reported liability, since no liability was previously reported.

CalPERS administers four defined benefit retirement plans: the Public Employees' Retirement Fund (PERF), the Judges' Retirement Fund (JRF), the Judges' Retirement Fund II (JRF II), and the Legislators' Retirement Fund (LRF). CalPERS also administers one defined benefit award plan, the Volunteer Firefighters' Length of Service Award Fund (VFF). CalPERS issues a publicly available financial report that includes financial statements and ten years of required supplementary information for these five plans. This report may be obtained by writing to the California Public Employees' Retirement System, Central Supply, P.O. Box 942715, Sacramento, California 94229-2715.

The State Teachers' Retirement System (STRS) administers two defined benefit retirement plans: Teachers' Retirement Fund (TRF) and the Cash Balance Plan (CBPlan). STRS issues a publicly available financial report that includes financial statements and ten years of required supplementary information. This report may be obtained from the State Teachers' Retirement System, Accounting Division, 7667 Folsom Blvd., 2nd Floor, Sacramento, California 95826.

*Summary of Significant Accounting Policies-CalPERS:*
*Basis of Accounting:* CalPERS uses the accrual basis of accounting. Contributions are recorded when due. Investment income is recognized when earned, and expenditures are recorded when incurred.

*Investments:* CalPERS investments are presented at fair value. Statutes authorize CalPERS to invest in stocks, bonds, mortgages, real estate, and other investments. CalPERS maintains certain deposits, cash equivalents, and other investments with financial institutions.

The fair value of investments in securities is generally based on published market prices and quotations from major investment firms. Many factors are considered in arriving at that fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock, less an appropriate discount.

Mortgages are valued on the basis of their future principal and interest payments discounted at prevailing interest rates for similar instruments. The fair value of real estate investments, principally rental property subject to long-term net leases, is estimated based on independent appraisals. Short-term investments are reported at market value, when published market prices and quotations are available, or at cost plus accrued interest, which approximat market value. For investments where no readily ascertainab market value exists, management, in consultation with their investment advisors, has determined the fair values for the individual investments.

*Summary of Significant Accounting Policies-STRS:*
*Basis of Accounting:* STRS uses the accrual basis of accounting. Contributions are recognized in the period in which the contributions are due. Income is recognized when earned and expenditures are recorded when incurred.

*Investments:* The majority of the securities held in the STRS investment portfolio as of June 30, 1997, are in the custody of, or controlled by, the State Street Bank & Trust Company, the master custodian of the STRS. The investments of the STRS consist of government, corporate, and international bonds, domestic and international equities, mutual funds, limited partnership holdings, real estate, mortgages, and other investments.

All investments are recorded at fair value. The fair value of investments is generally based on published market prices and quotations from major investment firms. In the case of debt securities acquired through private placements, fair value is computed by management based on market yields and average maturity dates of comparable quoted securities. Mortgages are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. Real estate equity investment fair values represent the most recent appraisals. Short-term investments are reported at cost, which approximates fair value.

Purchases and sales of debt securities, equity securities, and short term investments are recorded on the trade date. Real estate equity transactions are recorded on the settlement date. Upon sale of investments, the difference between sales proceeds and historical cost is reflected in the statement of changes in plan net assets.

Debt discounts are accreted to the bond maturity date and premiums are amortized to the earliest call date using an approximation of the interest method. Mortgage loan discounts are accreted over a 20-year period using the pay down method.

**A. Public Employees' Retirement Fund**
**1. Fund Information**

*Plan Description:* CalPERS administers the PERF, which is an agent multiple-employer retirement system. Employers participating in the PERF include the primary government and certain special purpose authorities, which are discretely presented component units, 61 school employers, and 1,293 public agencies as of June 30.

*Unfunded Actuarial Accrued Liability:* The unfunded actuarial accrued liability of PERF was $2.6 billion at June 30, 1996. This is a result of the difference between the actuarial value of assets of

$94.2 billion and the actuarial accrued liability of $96.8 billion. Contributions are actuarially determined.

**2. Employers' Information**

*Plan Description:* The primary government and certain special purpose authorities contribute to the PERF. The fund acts as a common investment and administrative agent of the primary government and the other member agencies. The special purpose authorities' participation in PERF is not a material portion of the program. The primary government has six pension plans within the PERF: first tier miscellaneous, second tier miscellaneous, industrial, California Highway Patrol, police officers and firefighters, and other safety members. The payroll for employees covered by the PERF in the year ended June 30, 1997, was approximately $9.1 billion.

All employees who work on a half-time or more basis are eligible to participate in the PERS. The PERS administers several different plans, each providing a monthly allowance based on age, years of credited service, benefit formulas, and highest final compensation averaged over 12 or 36 consecutive months. Vesting occurs after five or ten years, depending on the plan. All plans provide death and disability benefits. The benefit provisions are established by statute.

*Funding policy:* Benefits are funded by contributions from members and employers and earnings from investments. Member and employer contributions are a percentage of applicable member compensation. Member rates are defined by law and based on actuarial valuation. Employer contribution rates are determined by periodic actuarial valuations or by state statute.

Employees, with the exception of employees in the second tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on a percentage of salary over a monthly base compensation amount of $238 to $863. With the exception of employees in the second-tier plan, employees' required contributions vary from 5% to 8% of their salary over their base compensation amount.

The required employer contribution rates for the primary government are shown in Table 26.

**Table 26**

**Schedule of Required Employer Contribution Rates for the Primary Government by Member Category**
Year Ending June 30, 1997

| | Normal Cost | Unfunded Liability | Total Rate |
|---|---|---|---|
| Miscellaneous members | | | |
| First tier | 9.78 % | 3.33 % | 13.11 % |
| Second tier | 6.61 | 2.73 | 9.34 |
| Industrial | 10.18 | (0.92) | 9.26 |
| California Highway Patrol | 14.83 | 1.02 | 15.85 |
| Police officers and firefighters | 15.37 | 0.03 | 15.40 |
| Other safety members | 14.23 | 0.43 | 14.66 |

For the year ended June 30, 1997, the annual pension cost (APC) and the amount of contributions made for the primary government was approximately $1.3 and $1.6 billion respectively. The APC and the percentage of APC contributed for the last three years are shown in Table 27. Actuarial valuations of the PERF are performed annually. Information from the last valuation, which was performed as of June 30, 1996, is also shown in Table 27.

## B. Judges' Retirement Fund

*Plan Description:* CalPERS administers the JRF, which is an agent multiple-employer defined benefit retirement plan. The JRF membership includes justices of the Supreme Court and courts of appeal, as well as judges of superior courts, municipal courts, and justice courts appointed or elected prior to November 9, 1994. There are 59 employers participating in the JRF for the fiscal year ended June 30, 1997. The payroll for employees covered by the JRF for the fiscal year ended June 30, 1997, was approximately $148 million. The primary government pays the employer contributions for all employees covered by the JRF.

All justices and judges appointed or elected prior to November 9, 1994, are required to participate in the JRF. The JRF provides a monthly allowance based on age, years of credited service, benefit formula, and highest average compensation over an established period of time of one year. Vesting occurs after five years. The JRF provides death and disability benefits. Benefits for the JRF are established by the Judges' Retirement Law.

*Funding Policy:* The required contribution rates of active plan members are based on a percentage of salary over a base compensation amount. For the year ended June 30, 1997, the required contribution rate for the JRF was 8.0%.

The contributions of the JRF are not actuarially determined. Contributions are pursuant to state statute. Employer contributions are required to be 8.0% of applicable member compensation. The other funding to meet benefit payment requirements of the JRF is currently provided from the following sources: filing fees, which require varying amounts, depending on fee rate and number o filings; investments, which earn the current yield on short term investments; and the primary government's balancing contributions, as required by the Judges' Retirement Law. The balancing contributions are equal to an amount at least equal to the estimated benefits payable during the ensuing fiscal year less the sum of the estimated member contributions during the ensuing fiscal year, and net assets available for benefits at the beginning of the fiscal year ("pay as you go" basis).

The APC and the dollar amount of contributions made to the JRF for the year ended June 30, 1997, were $133 million and $51 million, respectively. The net pension obligation (NPO) of the JRF at June 30, 1997 was $546 million, an increase of $82 million over last year's balance of $464 million. The APC is comprised of $133 million for the annual required contribution (ARC), $39 million interest on the NPO, and $39 million for the adjustment to the ARC. An actuarial valuation of the JRF's assets and liabilities is made annually. The APC, the percentage of APC contributed, and the NPO for the last three years are shown in Table 27. Information on the last valuation, which was performed as of June 30, 1996, is also shown in Table 27.

### C. Judges' Retirement Fund II

*Plan Description:* CalPERS administers the JRF II, which is an agent multiple-employer defined benefit retirement plan. The membership of the JRF II includes justices of the same courts as covered by JRF who were appointed or elected subsequent to November 9, 1994. There are 59 employers participating in the JRF II. The payroll for employees covered by the JRF II for the fiscal year ending June 30, 1997 was approximately $15.4 million. The primary government pays the employer contributions for all employees covered by the JRF II.

All justices and judges appointed or elected on or subsequent to November 9, 1994 are required to participate in the JRF II. JRF II provides a monthly allowance based on age, years of credited service, benefit formula, and highest average compensation over an established period of time of one year. Vesting occurs after five years. The JRF II provides death and disability benefits. Benefits for the JRF II are established by the Judges' Retirement System II Law.

*Funding policy:* The required contribution rate of active plan members is based on a percentage of salary over a base compensation amount. For the year ended June 30, 1997, the required contribution rate for JRF II is 8.0%. For the year ended June 30, 1997, the primary government's contribution rate for the JRF II was 19.2% of applicable member compensation.

Actuarial valuations for the JRF II are required to be carried out annually. The legislated employer contribution rate will be adjusted periodically as part of the annual Budget Act in order to maintain or restore the actuarial soundness of the fund.

For the fiscal year ended June 30, 1997, the annual pension cost (APC) and the amount of contributions made for the JRF II were both approximately \$3.0 million. The APC and the percentage of APC contributed for year ended June 30, 1997 is shown in Table 27. An actuarial valuation of JRF II's assets and liabilities is made every year. Information on the last valuation which was performed as of June 30, 1996, is also shown in Table 27.

**D. Legislators' Retirement Fund**

*Plan Description:* CalPERS administers the LRF, which is an agent single-employer defined benefit retirement plan. The eligible membership of the LRF includes state legislators serving in the legislature prior to November 7, 1991, constitutional officers, and legislative statutory officers. The payroll for employees covered by the LRF in 1997 was approximately \$3.9 million.

The LRF provides a monthly allowance based on age, years of credited service, and the highest compensation while in office. Vesting occurs after five years. The plan provides death and disability benefits. Benefits for the LRF are established by the Legislators' Retirement Law.

The Legislators' Retirement Fund is currently in transition. The number of legislators eligible to participate in the LRF is rapidly declining as incumbent legislators leave office and are replaced by new legislators who are not eligible to participate in the program. Eventually, the only active members in the LRF will be approximately 14 Constitutional Officers (including the Insurance Commissioner and members of the Board of Equalization) and approximately four Legislative Statutory Officers. Without statutory changes regarding the payment of contributions to the LRF, this transition may significantly impact the financial status of the LRF.

*Funding Policy:* The contribution requirements of the LRF are based on actuarially determined rates. An actuarial valuation of the LRF's assets and liabilities is made annually. The last valuation was performed as of June 30, 1996. For the year ended June 30, 1997, the actual contributions made by employees were approximately 8% of covered payroll. For the year ended June 30, 1997, the primary government's funding rate was 18.81% of covered payroll and the actuarially determined rate was 49.01% based on the June 30, 1995, actuarial valuation.

The APC and the dollar amount of contributions made to the LRF for the year ended June 30, 1997, were \$1.9 million and \$2.5 million, respectively. The NPO of the LRF at June 30, 1997, was \$10.1 million, which is a decrease of \$0.5 million over last year's balance of \$10.6 million. The APC is comprised of \$1.9 million for the ARC, \$0.8 million interest on the NPO, and \$0.8 million for the adjustment to the ARC. The APC, the percentage of APC contributed, and the NPO for the last three years are shown in Table 27. An actuarial valuation of the LRF's assets and liabilities is made annually. Information on the last valuation, which was performed as of June 30, 1996, is also shown in Table 27.

### E. Volunteer Firefighters' Length of Service Award Fund

*Plan Description:* CalPERS administers the Volunteer Firefighters' Length of Service Award Fund (VFF), an agent multiple-employer public employee defined benefit award plan. It currently has 40 participating fire departments.

*Unfunded Actuarial Accrued Liability*: The unfunded actuarial accrued liability of VFF was $144,000 at June 30, 1996. This is a result of the difference between the actuarial value of assets of $934,000 and the actuarial accrued liability of $1,078,000, which is a funding ratio of 86.6%.

### F. Teachers' Retirement Fund

*Plan Description:* STRS administers the Teachers' Retirement Fund (TRF), a cost sharing multiple-employer defined benefit retirement plan, that provides pension benefits to teachers and certain other employees of the California public school system. Membership in the TRF is mandatory for all employees meeting the eligibility requirements. The TRF provides a monthly benefit based on age, members final compensation, and years of service. Vesting accrues after five years. In addition, the retirement plan provides benefits to members upon disability and to survivors upon the death of eligible members. The benefits for the TRF are established by the State Teachers' Retirement Law. At June 30, 1997, the TRF had approximately 1,157 contributing employers, approximately 400,000 plan members, and 155,000 benefit recipients. The primary government is a nonemployer contributor to the TRF. The payroll for employees covered by TRF in 1997 was approximately $12.7 billion.

*Funding policy:* Benefits are funded by contributions from members, employers, the primary government, and earnings from investments. Member and employer contributions are a percentage of applicable member earnings. Member rates, employer contribution rates, and primary government contributions are determined by the State Teachers' Retirement Law.

Contribution rates of members are 8% of applicable member earnings. Employer contribution rates are 8.25% of applicable member earnings. The primary government's contribution to the system under Education Code Section 22955,"Elder Full Funding Act", is 4.3% of the previous calendar year's member payroll. Subsequent to achieving a fully funded system, the primary government will contribute only the amount necessary to help fund the normal cost of the current benefit program unless a subsequent unfunded obligation occurs. Additionally, under certain provisions of the California Education Code, employers are required to make contribution 0.415% of the payroll to the primary government. Th contributions are appropriated by the primary government to TRF.

*Unfunded Actuarial Accrued Liability:* The unfunded actuarial accrued liability of the TRF was $8.2 billion at June 30, 1995. The Elder Full Funding Act (SB 1370) was enacted beginning July 1, 1991, to achieve full funding of the TRF. Based on the most current valuation (1995), the estimated amortization period to retire the actuarial accrued liability is 18 years.

**G. Cash Balance Fund**

*Cash Balance Plan Description:* STRS administers the CBPlan as a separate defined benefit plan designed for employees of California public schools who are hired to perform creditable service for less than 50% of the full time equivalent for the position. Participation in the CBPlan is optional to employers. However, if the employer elects to offer the CBPlan, each eligible employee will automatically be covered by the CBPlan unless the member elects to participate in the TRF or an alternative plan provided by the employer within 60 days of hire. At June 30, 1997, the CBPlan had two contributing school districts and approximately 478 contributing members. For reporting purposes, the CBPlan is combined with the TRF.

**Table 27**

**Actuarial Information – Pension Trusts – Primary Government**
June 30, 1997

| | Public Employees' Retirement | Judges' Retirement | Judges' Retirement II | Legislators' Retirement | Teachers' Retirement |
|---|---|---|---|---|---|
| Last actuarial valuation | June 30, 1996 | June 30, 1996 | June 30, 1996 | June 30, 1996 | June 30, 1995 |
| Actuarial cost method | Entry Age Normal | Entry Age Normal | Entry Age Normal | Entry Age Normal | Entry Age Normal |
| Amortization method | Level % of Payroll, Closed | Level Dollar, Open | Level % of Payroll, Closed | Level Dollar, Open | Level % of Payroll, Open |
| Remaining amortization period | 34 years | 30 years | 6.5 years | 30 years | 18 years |
| Asset valuation method | Smoothed Market Value | Cost Plus Accrued Interest | Cost | Smoothed Market Value | Expected Value, 25% Adjustment to Fair Value |
| Actuarial assumption | | | | | |
| Investment rate of return | 8.50 % | 8.50 % | 8.50 % | 7.75 % | 8.00 % |
| Projected salary increase | 4.5 – 10.0 | 4.75 | 5.75 | 4.50 | 5.50 |
| Includes inflation at | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 |
| Post retirement benefit increases | 2 or 3 | — | 3.00 | 4.50 | 2.00 |
| Annual pension costs (In millions) | | | | | |
| Year ended 6/30/95 | $ 1,085 | $ 117 | $ 0.1 | $ 2.3 | $ 1,589 |
| Year ended 6/30/96 | 1,169 | 104 | 1.6 | 2.3 | 1,726 |
| Year ended 6/30/97 | 1,283 | 133 | 3.0 | 1.9 | 1,835 |
| Percent contribution | | | | | |
| Year ended 6/30/95 | 93 % | 43 % | 100 % | 25 % | 100 % |
| Year ended 6/30/96 | 93 | 58 | 100 | 25 | 100 |
| Year ended 6/30/97 | 124 | 38 | 102 | 130 | 100 |
| Net pension obligation (In millions) | | | | | |
| Year ended 6/30/95 | $ 115.3 | $ 420.7 | $ — | $ 8.9 | $ — |
| Year ended 6/30/96 | 201.3 | 464.0 | — | 10.6 | — |
| Year ended 6/30/97 | — | 546.1 | — | 10.1 | — |
| Funding as of last valuation (In millions) | | | | | |
| Actuarial Value – Assets | 38,917 | 13 | 2.4 | 94 | 55,207 |
| Actuarial Accrued Liabilities (AAL) | 41,867 | 1,460 | 2.8 | 105 | 63,391 |
| Unfunded AAL (UAAL) | 2,950 | 1,447 | 0.4 | 11 | 8,184 |
| Covered Payroll | 8,924 | 154 | 8.1 | 4.8 | 12,688 |
| Funded Ratio | 93 % | 1 % | 85 % | 90 % | 87 % |
| UAAL as percent of covered payroll | 33 % | 940 % | 5 % | 229 % | 65 % |

### H. University of California Retirement System– Discretely Presented Component Unit

The UCRS consists of a single-employer, defined benefit plan funded with University and employee contributions, a defined benefit plan for University employees who elected early retirement under the Public Employees' Retirement System Voluntary Early Retirement Incentive Program (PERS-VERIP), and a defined contribution pl[illegible] with several investment portfolios funded with employee no[illegible] elective and elective contributions. Most University career employees participate in UCRS.

The UCRS provides lifetime retirement income, disability protection and preretirement survivor benefits to eligible employees of the University of California and its affiliates. Membership in the retirement plan is required for all employees appointed to work at least 50 percent time for a year or more. Generally, five years of service are required to be entitled to plan benefits. The maximum monthly benefit is 100 percent of the employee's highest average compensation over a 36-month period. The amount of the pension benefit is determined by salary rate, age, and years of service credit with certain cost-of-living adjustments.

Members' contributions are accounted for separately and accrue interest at six percent annually. Upon termination, members can elect a refund of their contributions plus accumulated interest. Vested terminated members who are eligible to retire can also elect a lump sum equal to the present value of their accrued benefits. Both actions thereby forfeit the member's rights to further accrued benefits.

The annually determined rates for employer contributions as a percentage of payroll are based on recommendations of the consulting actuary and appropriations received from the primary government.

Employee contributions may be required to be made to the University of California Retirement Plan. The rate of employee contributions is established annually pursuant to the Regents' funding policy, as a percentage of covered wages, recommended and certified by an enrolled, independent actuary and approved by the Regents, the plan's trustee. During the year ended June 30, 1997, employee contributions to the University of California Retirement Plan were redirected to the University of California Defined Contribution Plan.

There were no changes in actuarial assumptions or benefit provisions which significantly affected the actuarial accrued liability or contribution requirements during the year ended June 30, 1997.

The PERS-VERIP is a defined benefit pension plan providing lifetime supplemental retirement income and survivor benefits to members of the University of California CalPERS program (UC-PERS), who elected early retirement under provisions of the plan. The University contributed to the CalPERS on behalf of these UC-PERS members.

The cost of contributions made to the plan is borne entirely by the University and the Federal Department of Energy laboratories. Over the five-year period ended June 30, 1996, the University and the Federal Department of Energy laboratories were required to make contributions to the plan as determined by the plan's consulting actuary sufficient to maintain the promised benefits and the qualified status of the plan.

A defined contribution plan (the DCPlan), which provides savings incentives and additional retirement security for all eligible University employees, is maintained by the University. The DCPlan accepts both after-tax and pretax contributions by employees and has no employer contributions. Participants in the DCPlan may direct their contributions to investment funds managed by the Treasurer of the Regents of the University of California. They may also invest contributions in, and transfer plan accumulations to, certain external mutual funds on a custodial plan basis.

The DCPlan pretax contributions are fully vested and are mandatory for all employees who are members of the University of California Retirement Plan. Monthly employee contributions range from approximately 2% to 4% of covered wages depending upon whether wages are above or below the Social Security wage base. The DCPlan after-tax options are generally available to all University employees. During the year ended June 30, participants contributed $144 million into the DCPlan.

**Table 28**

**Actuarial Information – University of California – Discretely Presented Component Unit**
June 30, 1997

| | University of California Retirement Plan | | Voluntary Early Retirement Incentive Plan | |
|---|---|---|---|---|
| Last actuarial valuation | June 30, 1996 | | June 30, 1996 | |
| Actuarial cost method | Entry Age Normal | | Entry Age Normal | |
| Amortization method | Level % of Payroll, Open | | N/A Closed | |
| Remaining amortization period | 3 years | | — | |
| Asset valuation method | Smoothed Fair Value | | Smoothed Fair Value | |
| Actuarial assumption | | | | |
| Investment rate of return | | 7.50 % | | 7.50 % |
| Projected salary increase | | 4.5 to 6.5 | | N/A |
| Includes inflation at | | 4.00 | | N/A |
| Annual pension costs (In millions) | | | | |
| Year ended 6/30/97 | $ | — | $ | — |
| Percent contribution | | | | |
| Year ended 6/30/97 | | N/A | | N/A |
| Net pension obligation (In millions) | | | | |
| Year ended 6/30/97 | $ | — | $ | — |
| Funding as of last valuation (In millions) | | | | |
| Actuarial value – assets | $ | 19,736 | $ | 64 |
| Actuarial accrued liabilities (AAL) | | 17,925 | | 47 |
| Unfunded AAL (UAAL) | | — | | — |
| Covered payroll | | 4,500 | | N/A |
| Funded ratio | | 110 % | | 136 % |

## NOTE 25. POST-RETIREMENT HEALTH CARE BENEFITS

Health care and dental benefits are provided by the primary government and certain special purpose authorities, which are discretely presented component units, to annuitants of retirement systems to which the primary government contributes as an employer. The special purpose authorities' participation in these benefits are not a material portion of the program. To be eligible for these benefits, first tier plan annuitants must retire on or after attaining age 50 with at least five years of service, and second tier plan annuitants must retire on or after attaining age 55 with at least 10 years of service. In addition, annuitants must retire within

120 days of separation from employment to be eligible to receive these benefits. As of June 30, approximately 95,096 annuitants were enrolled to receive health benefits and approximately 90,563 annuitants were enrolled to receive dental benefits. In accordance with the Government Code, the primary government generally pays 100% of the health insurance cost for annuitants plus 90% of the additional premium required for the enrollment of family members of annuitants. Although the primary government generally pays 100% of the dental insurance premium for annuitants, the Government Code does not specify the primary government's contribution toward dental insurance costs. The primary government recognizes the cost of providing health and dental insurance to annuitants on a pay-as-you-go basis. The cost of these benefits for the year ended June 30 was approximately $266 million.

Also, the University of California, a discretely presented component unit, provides certain health plan benefits to retired employees in addition to pension benefits. Employees who meet specific requirements may continue their medical and dental benefits into retirement and continue to receive University of California contributions for those benefits. There are approximately 34,000 retirees currently eligible to receive such benefits. The cost of retiree medical and dental coverage is recognized when paid. The cost of providing medical and dental benefits for retirees and their families and survivors in the year ended June 30 was $88 million.

## NOTE 26. SUBSEQUENT EVENTS

The following information represents significant events that occurred subsequent to June 30, 1997, but prior to the date of the auditors' report.

On September 9, 1997, the primary government issued $3.0 billion in revenue anticipation notes that will mature on June 30, 1998. On October 23, 1997, the primary government issued $1.0 billion in general obligation bonds, $977 million of which were used to retire previously issued commercial paper. From July 1, 1997, to November 21, 1997, the primary government issued approximately $397 million in revenue bonds, $106 million of which were used to refund existing revenue bonds, and $76 million of which were used to retire previously issued commercial paper. Additionally, during the period, $51 million in certificates of participation were issued to refund existing outstanding certificates of participation.

On September 19, 1997, the Regents of the University of California authorized the merger of the San Francisco medical center, one of five medical centers owned by the University of California, a discretely presented component unit, with Stanford Health Services, a subsidiary of Stanford University which owns, manages ar operates its medical center.

From July 1, 1997, to November 21, 1997, the Regents of the University of California issued $284 million in revenue bonds.

From July 1, 1997, to November 21, 1997, the special purpose authorities, which are discretely presented component units, issued approximately $282 million in revenue bonds.

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**Appendix A - Exhibit 2**

STATE CONTROLLER'S STATEMENT OF
GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
December 1997
(Unaudited)



SOURCE: State of California, Office of the State Controller.

# STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
## A Comparison of Actual to 1997-98 Budget Act Estimates
## (Amounts in thousands)

| | July 1 through December 31 | | | | |
|---|---|---|---|---|---|
| | 1997 | | | | 1996 |
| | Actual | Estimate (a) | Actual Over or (Under) Estimate Amount (b) | % | Actual |
| **GENERAL FUND BEGINNING CASH BALANCE** | $ ------ | $ ------ | $ ------ | ------ | $ ------ |
| Add Receipts: | | | | | |
| Revenues | 23,950,084 | 23,745,690 | 204,394 | 0.9 | 22,687,682 |
| Nonrevenues | 235,232 | 180,236 | 54,996 | 30.5 | 347,169 |
| Total Receipts | 24,185,316 | 23,925,926 | 259,390 | 1.1 | 23,034,851 |
| Less Disbursements: | | | | | |
| State Operations | 8,200,768 | 8,134,802 | 65,966 | 0.8 | 7,246,283 |
| Local Assistance | 19,136,439 | 20,532,615 | (1,396,176) | (6.8) | 18,119,039 |
| Capital Outlay | 27,391 | 34,501 | (7,110) | (20.6) | 24,220 |
| Nongovernmental | (36,056) | (226,254) | 190,198 | ------ | 337,769 |
| Total Disbursements | 27,328,542 | 28,475,664 | (1,147,122) | (4.0) | 25,727,311 |
| Receipts Over / (Under) Disbursements | (3,143,226) | (4,549,738) | 1,406,512 | ------ | (2,692,460) |
| Net Increase / (Decrease) in Temporary Loans | 3,144,218 | 4,550,722 | (1,406,504) | (30.9) | 2,693,388 |
| **GENERAL FUND ENDING CASH BALANCE** | 992 | 984 | 8 | 0.8 | 928 |
| Special Fund for Economic Uncertainties (c) | ------ | ------ | ------ | ------ | ------ |
| **TOTAL CASH** | $ 992 | $ $984 | $ 8 | 0.8 | $ 928 |

| | | | | | |
|---|---|---|---|---|---|
| **BORROWABLE RESOURCES** | | | | | |
| Available Borrowable Resources | $ 9,479,993 | $ 8,781,616 | $ 698,377 | 8.0 | $ 8,722,441 |
| Outstanding Loans (d) | 4,334,606 | 5,741,110 | (1,406,504) | (24.5) | 4,147,424 |
| Unused Borrowable Resources (e) | $ 5,145,387 | $ 3,040,506 | $ 2,104,881 | 69.2 | $ 4,575,017 |

THIS REPORT IS BASED UPON FUNDED CASH. FUNDED CASH IS CASH REPORTED TO AND RECORDED IN THE RECORDS OF THE STATE CONTROLLER'S OFFICE. AMOUNTS REPORTED AS FUNDED CASH MAY DIFFER FROM AMOUNTS IN OTHER REPORTS TO THE EXTENT THERE ARE TIMING DIFFERENCES IN THE RECORDING OF INTRANSIT ITEMS.

Footnotes:
(a) Statement of Estimated Cash Flow for the 1997-98 fiscal year as presented in the Budget Act of 1997.
(b) May not add to total due to rounding.
(c) Includes the Disaster Response-Emergency Operations Account within the Special Fund for Economic Uncertainties.
(d) Cumulative loan balance as of December 31, 1997 was $4.335 billion, which consists of a $3.0 billion 1997 Revenue Anticipa' Note, and $1.335 billion from internal sources.
(e) $5.145 billion available to be borrowed from internal sources.

## SCHEDULE OF CASH RECEIPTS
(Amounts in thousands)

| | Month of December | | July 1 through December 31 | | | | |
|---|---|---|---|---|---|---|---|
| | | | 1997 | | | | 1996 |
| REVENUES | 1997 | 1996 | Actual | Estimate (a) | Actual Over or (Under) Estimate Amount (b) | % | Actual |
| Alcoholic Beverage Excise Tax | $ 22,313 | $ 22,469 | $ 142,749 | $ 122,589 | $ 20,160 | 16.4 | $ 140,688 |
| Bank and Corporation Tax | 920,328 | 771,498 | 2,416,043 | 2,610,127 | (194,084) | (7.4) | 2,570,351 |
| Cigarette Tax | 22,970 | 25,203 | 86,685 | 82,808 | 3,877 | 4.7 | 88,688 |
| Horse Racing Fees | 5,691 | 3,769 | 14,507 | 17,244 | (2,737) | (15.9) | 16,532 |
| Inheritance, Gift and Estate Taxes | 51,412 | 72,579 | 346,584 | 334,903 | 11,681 | 3.5 | 481,135 |
| Insurance Companies Tax | 281,276 | 275,474 | 559,397 | 592,168 | (32,771) | (5.5) | 649,820 |
| Personal Income Tax | 2,792,417 | 2,320,013 | 11,464,246 | 11,086,935 | 377,311 | 3.4 | 10,293,914 |
| Retail Sales and Use Taxes | 1,716,138 | 1,509,069 | 8,369,065 | 8,338,773 | 30,292 | 0.4 | 7,794,921 |
| Pooled Money Investment Interest | 18,203 | 17,540 | 114,609 | 104,065 | 10,544 | 10.1 | 105,203 |
| Trial Court Revenues (c) | 28,580 | 27,493 | 166,639 | 157,445 | 9,194 | 5.8 | 163,712 |
| Not Otherwise Classified | 36,172 | 30,793 | 269,560 | 298,633 | (29,073) | (9.7) | 382,718 |
| **Total Revenues** | **5,895,500** | **5,075,900** | **23,950,084** | **23,745,690** | **204,394** | **0.9** | **22,687,682** |
| **NONREVENUES** | | | | | | | |
| Transfers from Special Fund for Economic Uncertainties | — | 28,167 | — | — | — | — | 28,167 |
| Transfers from Other Funds | 1,966 | 7,200 | 107,172 | 80,636 | 26,536 | 32.9 | 157,653 |
| Miscellaneous | 10,615 | 2,584 | 128,060 | 99,600 | 28,460 | 28.6 | 161,349 |
| **Total Nonrevenues** | **12,581** | **37,951** | **235,232** | **180,236** | **54,996** | **30.5** | **347,169** |
| **Total Receipts** | **$ 5,908,081** | **$ 5,113,851** | **$ 24,185,316** | **$ 23,925,926** | **$ 259,390** | **1.1** | **$ 23,034,851** |

(a) Statement of Estimated Cash Flow for the 1997-98 fiscal year as presented in the Budget Act of 1997.
(b) May not add to total due to rounding.
(c) Previously included in "Not Otherwise Classified".

## SCHEDULE OF CASH DISBURSEMENTS
(Amounts in thousands)

| | Month of December | | July 1 through December 31 | | | | |
|---|---|---|---|---|---|---|---|
| | | | 1997 | | | | 1996 |
| STATE OPERATIONS | 1997 | 1996 | Actual | Estimate (a) | Actual Over or (Under) Estimate Amount (b) | % | Actual |
| Legislative/Judicial/Executive | $ 57,961 | $ 69,379 | $ 466,083 | $ 449,828 | $ 16,255 | 3.6 | $ 457,887 |
| State and Consumer Services | 28,792 | 27,202 | 181,321 | 183,013 | (1,692) | (0.9) | 175,538 |
| Business, Transportation & Housing | 693 | 198 | 12,229 | 3,830 | 8,399 | 219.3 | 3,597 |
| Trade and Commerce | 3,739 | 2,166 | 16,802 | 15,645 | 1,157 | 7.4 | 18,239 |
| Resources | 58,410 | 35,675 | 326,718 | 299,582 | 27,136 | 9.1 | 346,309 |
| CA Environmental Protection Agency | 6,246 | 8,206 | 39,136 | 58,573 | (19,437) | (33.2) | 42,641 |
| Health & Welfare: | | | | | | | |
| Health Services | (690) | 21,437 | 144,505 | 133,041 | 11,464 | 8.6 | 149,121 |
| Mental Health Hospitals | 13,456 | 20,565 | 183,032 | 198,156 | (15,124) | (7.6) | 190,792 |
| Other Health and Welfare | 430 | 40,160 | 121,377 | 136,065 | (14,688) | (10.8) | 126,283 |
| Education: | | | | | | | |
| University of California | 176,484 | 183,016 | 1,144,653 | 1,186,880 | (42,227) | (3.6) | 1,192,174 |
| California State University | 166,942 | 146,426 | 1,020,345 | 962,210 | 58,135 | 6.0 | 905,736 |
| Other Education | 3,276 | 11,763 | 76,934 | 76,355 | 579 | 0.8 | 68,876 |
| Corrections and Youth Authority | 313,140 | 297,148 | 1,976,862 | 1,653,348 | 323,514 | 19.6 | 1,942,994 |
| General Government | 61,934 | 51,911 | 366,171 | 651,851 | (285,680) | (43.8) | 382,713 |
| Public Employees Retirement System | (63,694) | (63,465) | 1,043,096 | 1,051,132 | (8,036) | (0.8) | 75,254 |
| Debt Service (c) | 31,649 | 33,035 | 1,072,055 | 1,065,844 | 6,211 | 0.6 | 1,113,957 |
| Interest on Loans | ------ | 2,808 | 9,449 | 9,449 | ------ | ------ | 54,172 |
| **Total State Operations** | **858,768** | **887,630** | **8,200,768** | **8,134,802** | **65,966** | **0.8** | **7,246,283** |
| **LOCAL ASSISTANCE** | | | | | | | |
| Public Schools - K-12 | 1,462,747 | 1,405,219 | 8,430,540 | 9,989,682 | (1,559,142) | (15.6) | 8,221,465 |
| Community Colleges | 83,137 | 69,658 | 935,111 | 1,041,361 | (106,250) | (10.2) | 839,131 |
| Debt Service - State School Building Bonds | ------ | 75 | 288 | 225 | 63 | 28.0 | 4,327 |
| Contributions to State Teachers' Retirement System | ------ | ------ | 637,379 | 635,271 | 2,108 | 0.3 | 600,962 |
| Other Education | 206,595 | 79,339 | 658,067 | 578,812 | 79,255 | 13.7 | 420,652 |
| Corrections and Youth Authority | 3,322 | 3,214 | 50,816 | 28,744 | 22,072 | 76.8 | 45,632 |
| Dept. of Alcohol and Drug Program | 13,228 | 3,440 | 54,543 | 39,776 | 14,767 | 37.1 | 45,260 |
| Dept. of Health Services: | | | | | | | |
| Medical Assistance Program | 984,554 | 677,222 | 3,772,132 | 3,493,489 | 278,643 | 8.0 | 3,255,381 |
| Other Health Services | 16,825 | 31,230 | 120,742 | 144,638 | (23,896) | (16.5) | 108,820 |
| Dept. of Developmental Services | 68,913 | 17,303 | 362,792 | 247,451 | 115,341 | 46.6 | 264,235 |
| Dept. of Mental Health | 179,089 | (27,804) | 252,460 | 244,750 | 7,710 | 3.2 | 126,013 |
| Dept. of Social Services: | | | | | | | |
| Supplementary Payments for Adults | 167,349 | 167,082 | 990,559 | 1,026,939 | (36,380) | (3.5) | 1,029,344 |
| Cash Assistance to Families and Children (d) | 150,345 | 253,934 | 1,355,337 | 1,422,613 | (67,276) | (4.7) | 1,708,933 |
| Other Social Services | 115,164 | 43,669 | 592,963 | 719,688 | (126,725) | (17.6) | 692,360 |
| Tax Relief | 144,497 | 137,906 | 217,803 | 225,908 | (8,105) | (3.6) | 219,515 |
| School Facility Aid Program | ------ | ------ | 35,468 | 34,550 | 918 | 2.7 | 40,588 |
| Other Local Assistance | 40,711 | 29,017 | 669,439 | 658,718 | 10,721 | 1.6 | 436,421 |
| **Total Local Assistance** | **3,636,476** | **2,890,504** | **19,136,439** | **20,532,615** | **(1,396,176)** | **(6.8)** | **18,119,039** |

(Continued)

## SCHEDULE OF CASH DISBURSEMENTS (Continued)
(Amounts in thousands)

| | Month of December | | July 1 through December 31 | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 1997 | | | | 1996 | |
| | 1997 | 1996 | Actual | Estimate (a) | Actual Over or (Under) Estimate Amount (b) | Actual Over or (Under) Estimate % | Actual | |
| **CAPITAL OUTLAY** | **6,687** | **1,601** | **27,391** | **34,501** | **(7,110)** | **(20.6)** | **24,220** | |
| **NONGOVERNMENTAL (e)** | | | | | | | | |
| Transfer to Special Fund for Economic Uncertainties | —— | 305,000 | —— | —— | —— | —— | 305,000 | |
| Transfer to Other Funds | 12,148 | 35,342 | 125,419 | 63,316 | 62,103 | 98.1 | 119,003 | |
| Transfer to Revolving Fund | (4,526) | 38,499 | 62,963 | (13,302) | 76,265 | —— | 58,067 | |
| School Loan (f) | —— | —— | —— | (92,760) | 92,760 | —— | —— | |
| Advance: | | | | | | | | |
| Earthquake Loan Repayment | —— | —— | 45,490 | 45,490 | —— | —— | 46,712 | |
| State-County Property Tax Administration Program | 81 | 24,202 | (25,387) | (43,396) | 18,009 | —— | 31,820 | |
| Social Welfare Federal Fund | (11,396) | 387,524 | (113,290) | (167,311) | 54,021 | —— | (55,947) | |
| Tax Relief and Refund Account | (47,800) | (41,500) | 52,000 | 72,200 | (20,200) | (28.0) | 50,800 | |
| Counties for Social Welfare | —— | (253,590) | (183,251) | (183,251) | —— | —— | (217,686) | |
| **Total Nongovernmental** | **(51,493)** | **495,477** | **(36,056)** | **(226,254)** | **190,198** | —— | **337,769** | |
| **Total Disbursements** | **$ 4,450,438** | **$ 4,275,212** | **$ 27,328,542** | **$ 28,475,664** | **$ (1,147,122)** | **(4.0)** | **$ 25,727,311** | |
| **TEMPORARY LOANS** | | | | | | | | |
| Special Fund for Economic Uncertainties | $ (65) | $ 276,899 | $ (1,065) | $ —— | $ (1,065) | —— | $ 276,628 | |
| Other Internal Sources | (1,457,500) | (1,115,600) | 145,283 | 1,550,722 | (1,405,439) | (90.6) | (583,240) | |
| Revenue Anticipation Notes | —— | —— | 3,000,000 | 3,000,000 | —— | —— | 3,000,000 | |
| **Net Increase / (Decrease), Loans** | **$ (1,457,565)** | **$ (838,701)** | **$ 3,144,218** | **$ 4,550,722** | **$ (1,406,504)** | **(30.9)** | **$ 2,693,388** | |

(a) Statement of Estimated Cash Flow for the 1997-98 fiscal year as presented in the Budget Act of 1997.
(b) May not add to total due to rounding.
(c) Excludes State School Building Bonds.
(d) Previously classified as "Aid to Families with Dependent Children".
(e) Negative balances are the result of repayments received that are greater than disbursements made.
(f) Non-Cash transaction.

(Concluded)

# COMPARATIVE STATEMENT OF REVENUES RECEIVED
## All Governmental Cost Funds
## (Amounts in thousands)

| | July 1 through December 31 | | | |
|---|---|---|---|---|
| | General Fund | | Special Funds | |
| | 1997 | 1996 | 1997 | 1996 |
| **MAJOR TAXES, LICENSES, AND INVESTMENT INCOME:** | | | | |
| Alcoholic Beverage Excise Taxes | $ 142,749 | $ 140,688 | $ ----- | $ ----- |
| Bank and Corporation Tax | 2,416,043 | 2,570,351 | 4 | ----- |
| Cigarette Tax | 86,685 | 88,688 | 253,601 | 258,297 |
| Estate Tax | 346,113 | 479,005 | ----- | ----- |
| Gift Tax | 2 | 37 | ----- | ----- |
| Horse Racing Fees | 14,507 | 16,532 | 24,613 | 24,330 |
| Inheritance Tax | 469 | 2,093 | ----- | ----- |
| Insurance Companies Tax | 559,397 | 649,820 | ----- | ----- |
| Motor Vehicle Fuel Tax: | | | | |
| Gasoline Tax | ----- | ----- | 1,267,635 | 1,268,531 |
| Diesel & Liquid Petroleum Gas | ----- | ----- | 209,996 | 193,207 |
| Jet Fuel Tax | ----- | ----- | 866 | 833 |
| Vehicle License Fees | ----- | ----- | 1,831,398 | 1,739,062 |
| Motor Vehicle Registration and Other Fees | ----- | ----- | 830,371 | 805,467 |
| Personal Income Tax | 11,464,246 | 10,293,914 | 216 | 201 |
| Retail Sales and Use Taxes | 8,369,065 | 7,794,921 | 1,766,849 | 1,611,553 |
| Pooled Money Investment Interest | 114,609 | 105,203 | 304 | 294 |
| Trial Court Revenues | 166,639 | 163,712 | ----- | ----- |
| **Total Major Taxes, Licenses, and Investment Income** | **23,680,524** | **22,304,964** | **6,185,853** | **5,901,775** |
| **NOT OTHERWISE CLASSIFIED:** | | | | |
| Alcoholic Beverage License Fee | 2,199 | 2,877 | 15,973 | 14,076 |
| Electrical Energy Tax | ----- | ----- | 22,817 | 21,900 |
| Private Rail Car Tax | 5,952 | 6,583 | ----- | ----- |
| Penalties on Traffic Violations | ----- | ----- | 32,481 | 31,265 |
| Health Care Receipts | 6,782 | 11,058 | ----- | ----- |
| Revenues from State Lands | 13,741 | 38,683 | 7,918 | ----- |
| Water's Edge Election Fee | ----- | ----- | ----- | ----- |
| Abandoned Property | 108,486 | 182,286 | ----- | ----- |
| Miscellaneous | 132,400 | 141,231 | 1,592,156 | 1,497,932 |
| **Not Otherwise Classified** | **269,560** | **382,718** | **1,671,345** | **1,565,173** |
| **Total Revenues, All Governmental Cost Funds** | **$ 23,950,084** | **$ 22,687,682** | **$ 7,857,198** | **$ 7,466,948** |

# APPENDIX B
# THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND

This Appendix B includes information about the Department, its Program, the 1943 Fund (including audited financial statements), and the Department's allocation of receipts from Contracts of Purchase, including Excess Revenues.

## THE DEPARTMENT

### General

In 1921 the California Legislature created the Veterans' Welfare Board and the Program. The Department of Veterans Affairs became the successor to the Board under the Farm and Home Purchase Act of 1943. The Department is a subdivision of the State and constitutes a public corporation. One of the Department's basic objectives is to afford eligible veterans the opportunity of acquiring homes with long-term low-interest financing provided under the Program.

There are four principal divisions within the Department: the Division of Veterans Services, the Division of Administration, the Veterans' Home Division and the Division of Farm and Home Purchases. The Program is administered by the Division of Farm and Home Purchases with support from the Division of Administration and other Department support units. No moneys generated by the Program may be used for any purpose other than providing farm, home and mobile home financing to veterans under the Program, paying debt service on veterans general obligation bonds and on the revenue bonds, financing home and property improvements for properties which have been financed under the Program, and paying costs associated with the administration of the Program.

### Administration

The California Veterans Board ("Board") determines the policies for all operations of the Department. The Board is composed of seven members: the Secretary of Veterans Affairs and six public members appointed by the Governor of the State for respective terms of four years. All of the members of the Board must be veterans, and membership is subject to confirmation by the State Senate. One of these members must be retired from the active or reserve forces of the United States military service.

In addition to its headquarters in Sacramento, the Division of Farm and Home Purchases maintains field offices located throughout the State. These local offices, in addition to providing information to all veterans concerning the Program, are responsible for the collection and evaluation of data regarding applicants for the Program and the property to be acquired under the Program. This includes an examination as to the qualification of veterans to participate in the Program, a credit analysis, an appraisal of properties and the initial processing of the veteran's application for a Contract of Purchase.

Loan origination and servicing of the Contracts of Purchase are performed by the Department at its headquarters, and entail mortgage loan accounting, insurance and property damage claims adjustment and services, Contract of Purchase alterations and contract performance services. General administration of the Program, including fiscal, legal, personnel and other administrative functions, is also performed at the Department's headquarters. As of December 31, 1997, the Department's Farm and Home Purchases Division had a staff of 121 persons.

The Secretary and other staff personnel of the Department principally responsible for the administration of the Program are listed below. The Secretary is appointed by the Governor of the State, serves at the pleasure of the Governor, and must be a veteran.

*Colonel Jay R. Vargas, USMC (RET)*
*Secretary since June 1993*

Secretary Vargas retired from the United States Marine Corps with the rank of Colonel after a distinguished 31-year career. In 1970 he received our nation's highest military honor when, in a White House ceremony conducted by President Richard Nixon, he was awarded the Congressional Medal of Honor. He commanded Marines at every level from Rifle Platoon to Infantry Regiment. His final tour of military duty was as Force Marine on the staff of Commander, U.S. Forces, Pacific.

Secretary Vargas attended Arizona State University and earned the degree of Bachelor of Science in Education. During his career as a Marine officer, he continued his education and earned the degree of Master of Arts in Education from the United States International University in San Diego, California, and graduated from the Marine Corps Command and Staff College and the Naval War College. In addition to the Medal of Honor, Secretary Vargas is the recipient of numerous military decorations, and has been honored by the American Academy of Achievement with its "Gold Plate Award."

*Lee Bennett*
*Undersecretary since October 1995*

On October 2, 1995, Governor Pete Wilson appointed Lee Bennett as the Undersecretary of the Department. A U.S. Navy veteran, Mr. Bennett was employed by the California Legislature for 29 years prior to his appointment. He graduated from California State University, Sacramento ("CSUS"), in 1970 with a Bachelor of Arts in Social Science and, in 1976, he received a Master of Arts in Behavioral Sciences from CSUS.

As a legislative employee, Mr. Bennett served in a number of key positions in both houses of the Legislature. Most recently, he served as the Senate Rules Committee consultant and staff director for Senator Robert G. Beverly. Prior to that, he was staff director for the Senate Republican Fiscal Consultants where his principal responsibility involved the development of the annual budget act and the review of bills assigned to the Senate Appropriations Committee. A credentialed teacher, he has also taught evening adult education classes in American Government.

*Leon Tuttle*
*Deputy Secretary, Operations since September 1995*

Mr. Tuttle graduated from the University of Wyoming and holds Master's Degrees in Business from Michigan State University and the University of Southern California. He is also a certified public accountant. He served on active duty in the U.S. Air Force from 1956 until 1980, when he retired with the rank of Colonel. During his service career, he served in flying operations jobs and, in the latter years of his service, held positions in budgeting, auditing and accounting. His last assignment was as Director of Plans and Systems at the Air Force Accounting and Finance Center in Denver, Colorado. Since completing his service career, he has worked in senior financial management positions in both private industry and state government.

*Loren Suter*
*Deputy Secretary, Administration since August 1995*

On August 28, 1995, Colonel Jay R. Vargas appointed Mr. Suter to the Chief, Finance Division position. This position was elevated to Deputy Secretary, Administration on March 4, 1996. Mr. Suter has been with the State of California in various finance and social service program executive positions for the past eighteen years. He was also in various finance staff positions for ten years. In 1968, Mr. Suter graduated from California State University - Sacramento with a Bachelor of Science Degree in Accounting.

*Mike Madalo*
*Chief, Farm and Home Purchases Division since April 1997*

Mr. Madalo was appointed as Chief of the Farm and Home Purchases Division on April 1, 1997. He graduated in 1962 from the U.S. Naval Academy, Annapolis, Maryland, and holds a Bachelor of Science degree in Engineering. He served on active duty in the United States Marine Corps from 1962 to 1966 as a fighter bomber pilot in Vietnam. Mr. Madalo held positions, including Plant Manager, General Manager, and Marketing Manager, with the American Cyanamid Company. He was Vice President in charge of Operations for LAMAUR, Inc., in Minneapolis, Minnesota; President/Owner of Empire Aire Aviation, Inc., in Fresno, California; President of Sun Laboratories of Atlanta, Inc., in Atlanta, Georgia; and Owner/President of PMI Consulting, in Fair Oaks, California.

*Delores A. McKinnon*
*Chief, Bond Finance Division since December 1994*

Ms. McKinnon is a graduate of Revelle College at the University of California, San Diego. From 1973 to 1981 she served as a research analyst, budget analyst and Assistant Budget Officer for the Department of Social Services. At the State Treasurer's Office from 1981 to 1984, she was a security trader and credit analyst for the State's Pooled Money Investment Account. From 1984 to December 1994, Ms. McKinnon held a variety of financial management positions with the State Treasurer's Office, including overseeing the sale and issuance of State bonds and trustee, paying agent and securities clearance services provided by such office.

*Craig Stevenson*
*Chief Counsel since September 1996*

Mr. Stevenson is a graduate of the University of California at Berkeley and the University of California at Davis School of Law. He served on active duty for three years in the U.S. Army Judge Advocate General Corps., followed by over twenty years' service in the California National Guard, from which he retired in 1996 with the grade of lieutenant colonel.

Mr. Stevenson was employed in Glenn County, California as the Assistant District Attorney for seven years and then was elected District Attorney for two terms. He entered private practice for almost four years and then worked at the Department of Motor Vehicles from October, 1994 until 1996.

## THE PROGRAM

### General

The Department began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature ("Legislature") of the Veterans Farm and Home Purchase Act of 1921. In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 ("1943 Act") which modified the Program to meet new needs of veterans. The 1943 Act was superseded by the Veterans Farm and Home Purchase Act of 1974 ("1974 Act") which again modified the Program. The 1943 Act established the 1943 Fund in the State Treasury, which is the principal fund utilized by the Program.

Since its inception, the Program has assisted over 405,000 veterans to purchase farms and homes throughout the State through long term housing and farm loans. The sales of Revenue Bonds and Veterans G.O. Bonds, combined with surplus revenues from borrowers under the Program not needed at any given time to meet the then current bond retirement schedules and operating costs, have provided approximately $9,710,463,000 for the purchase of farms and homes since Program inception. As of December 31, 1997 there were 37,607 Contracts of Purchase outstanding with a remaining principal balance of $2,167,853,265. See Exhibit 2—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase" and "—Amounts Expected to be Available to Finance Contracts of Purchase and Related Investments" for information regarding existing Contracts of Purchase and moneys available to finance additional Contracts of Purchase.

The description of the Program under this heading is a description of the Program as it currently exists under the Veterans Code and the Department's implementation thereof. The Military and Veterans Code (the "Veterans Code") of the State and the Department's implementation thereof are subject to change. The Program is also subject to the Internal Revenue Code of 1986, as amended (the "Federal Tax Code"), as noted below.

**Qualifying Veteran Status**

*Veterans Code.* A veteran must meet qualifications established under State law in the Veterans Code in order to participate in the Program. The qualifications specified in the Veterans Code are subject to change by the Legislature. The Veterans Code currently requires, generally, that a veteran must have served at least ninety days on active duty in the Armed Forces of the United States, unless sooner discharged because of a service-connected disability, or as a member of the National Guard or reserves called to active duty by Presidential order, and must have received an honorable discharge or been released from active duty under honorable conditions. The Veterans Code (including recent amendments effective January 1, 1998) allows the Department to finance Contracts of Purchase for

(a) veterans who have served during a period which includes service in one of the following periods:

(i) April 6, 1917 through November 11, 1918; December 7, 1941 through December 31, 1946; or June 27, 1950 through January 31, 1955 (such veterans are referred to as "Earlier War Veterans");

(ii) February 28, 1961 through August 4, 1964 if the veteran served in the Republic of Vietnam during that period ("Early Vietnam Veterans"); or August 5, 1964 through May 7, 1975 (all veterans referred to in this clause (ii) are "Vietnam Era Veterans"); or

(iii) on or after August 2, 1990, through a date as yet to be determined by the President of the United States; at any time in Somalia, or in direct support of the troops in Somalia, during Operation Restore Hope; or at any time in an expedition or campaign for which a medal was authorized by the United States Government such as the Armed Forces Expeditionary and Vietnam Service Medals (such veterans are referred to as "Recent War Veterans"); and

(b) any person who qualifies under the Federal Tax Code for financing from revenue bonds or unrestricted funds of the Department and who served in the active military, naval, or air service for a period of not less than 90 consecutive days and who received an honorable discharge or was released from active duty under honorable conditions (such veterans are referred to as "Peacetime Veterans").

The amendments to the Veterans Code effective January 1, 1998 added Early Vietnam Veterans and Peacetime Veterans as veterans eligible to receive Contracts of Purchase. The Department expects these amendments to significantly increase the universe of potential contract holders, and to increase demand for Contracts of Purchase.

*Federal Tax Code.* In order to determine which Department moneys can be used to finance Contracts of Purchase, the Department must also take into account the requirements of federal law set forth in the Federal Tax Code, which can limit the universe of veterans eligible to receive Contracts of Purchase financed from certain sources. Applying the current Federal Tax Code separates the Department's lendable moneys into three classes:

(A) "Unrestricted Moneys" (derived from certain moneys in the 1943 Fund and certain proceeds of pre-Ullman revenue bonds and veterans general obligation bonds, including certain future issues of taxable bonds, if any), which can finance Contracts of Purchase for those veterans who qualify under the applicable provisions of the Veterans Code (there are no loan eligibility requirements imposed by the Federal Tax Code with respect to Contracts of Purchase financed by such moneys; these are requirements principally limiting the family income of applicants and the property purchase price, and, subject to certain exceptions, requiring that the veteran not have had a present ownership interest in his principal residence in the three years prior to obtaining such financing ("QMB Loan Eligibility Requirements")). The Department has implemented a policy (which is subject to change) to make such moneys available for Earlier War Veterans, Vietnam Era Veterans, and Recent War Veterans.

(B) "Qualified Veterans Mortgage Bond Proceeds" (derived exclusively from proceeds of Veterans G.O. Bonds) which can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code, (ii) served on active duty prior to January 1, 1977, and (iii) was released from active duty fewer than 30 years before receiving such financing. The last date of veteran eligibility under clause (iii) is December 31, 2036 for a veteran with 30 years of continuous service after December 31, 1976. (The QMB Loan Eligibility Requirements do not apply to Contracts of Purchase financed by such moneys.) These proceeds can finance Contracts of Purchase for Earlier War Veterans and Vietnam Era Veterans; and

(C) "Qualified Mortgage Bond Proceeds" (which are principally derived from Revenue Bond proceeds), can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code, and (ii) satisfies the QMB Loan Eligibility Requirements. These proceeds can finance Contracts of Purchase for all veterans.

**Allocation of Lendable Moneys**

For those veterans seeking financing who would qualify for Contracts of Purchase from two or more of the above-described financing sources, the Department will select the source of funds to use in its sole discretion. The Department's goal is to maximize the availability of Program benefits. The Board has approved a policy (which is subject to change) to make Qualified Mortgage Bond Proceeds derived from Revenue Bonds the only financing source for Contracts of Purchase for veterans who did not serve during "wartime" (as defined in the Veterans Code).

**Administration of the Farm and Home Purchase Program**

The Department finances new and existing single-family homes, farms and mobile homes located in the State by acquiring the property selected by a veteran under a Contract of Purchase. The Department also finances home improvements with respect to properties covered by existing Contracts of Purchase, subject to applicable restrictions of the Federal Tax Code. A Contract of Purchase creates an installment land contract between the Department and the veteran which is analogous to a loan from the Department to the veteran. The amount which the Department finances is reflected in the Contract of Purchase as the "purchase price."

At present under the Veterans Code, the maximum purchase price to the Department of an existing home or the sum to be expended by the Department pursuant to a Contract of Purchase for a home to be constructed is $250,000 and for farms is $300,000 (except that the limitation with respect to certain mobile homes in mobile home parks is $70,000 and except that the maximum purchase price for any home may be increased by an additional $5,000 for certain purposes). The Legislature has periodically made changes in the maximum amount that may be financed under a

Contract of Purchase. The Federal Tax Code imposes maximum purchase prices on properties which are the subject of Contracts of Purchase financed by Qualified Mortgage Bond Proceeds, which maximums are adjusted periodically. (No Federal Tax Code purchase price limits apply to Contracts of Purchase financed from Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds). These Federal Tax Code requirements vary depending upon where the property is located, if it is in a targeted or non-targeted area, and whether it is a new or existing home. These Federal Tax Code limits currently range from $88,266 to $313,512. The maximum purchase price under the Program is, therefore, the Veterans Code maximum amount or, if the Contract of Purchase is being financed by Qualified Mortgage Bond Proceeds, the lesser of the Veterans Code maximum amount or the maximum amount under applicable provisions of the Federal Tax Code.

Although the Veterans Code does not impose maximum income limits, the Federal Tax Code imposes maximum income limits applicable only to veterans obtaining Contracts of Purchase financed by Qualified Mortgage Bond Proceeds. The income limits vary by statistical area and family size. No maximum income limits apply to veterans obtaining Contracts of Purchase financed by Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds.

Under amendments to the Veterans Code which were effective January 1, 1998, any veteran who qualifies under the Veterans Code and the Federal Tax Code may be granted a subsequent Contract of Purchase so long as any previous Contract of Purchase has been paid in full or the veteran lost his interest in the previous Contract of Purchase through divorce or dissolution of marriage.

**Contracts of Purchase**

*General.* Pursuant to the Program, the Department and the veteran enter into a Contract of Purchase for a farm, home or mobile home. Under a Contract of Purchase, the veteran has the benefits of ownership as the equitable owner, but title to the property and improvements is held by the Department as the legal owner until the final principal payment is made. Property sold under a Contract of Purchase may not be transferred, assigned, encumbered, leased, let or sublet without the written consent of the Department. Any permitted encumbrance must be junior or secondary to the Department's interest in the property. Existing Contracts of Purchase are not insured or guaranteed by the Federal Housing Administration, the USDVA, Rural Housing Service or any private primary mortgage insurer. However, aggregate losses above 3% on a pool of certain Contracts of Purchase with loan-to-value ratios above 80% are expected to be covered by mortgage insurance to be provided by Commonwealth Mortgage Assurance Company ("CMAC"), which contract, once executed, is expected to retroactively cover losses incurred since February 1, 1998. USDVA guarantees are expected to be obtained on all eligible new Contracts of Purchase beginning March 1, 1998.

The terms of the Contracts of Purchase are substantially identical regardless of whether they are funded by Unrestricted Moneys, Qualified Veterans Mortgage Bond Proceeds or Qualified Mortgage Bond Proceeds, except for Federal Tax Code-mandated differences in Contracts of Purchase financed with Qualified Mortgage Bond Proceeds. Two ways in which such Contracts of Purchase are different are: (a) Contracts of Purchase financed by Qualified Mortgage Bond Proceeds have more restrictions on the right of a purchaser to assume the obligations under the Contract of Purchase than do Contracts of Purchase financed by Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds; and (b) certain Contracts of Purchase financed by Qualified Mortgage Bond Proceeds are subject to recapture provisions. In addition, the Federal Tax Code contains numerous loan eligibility restrictions on borrowers receiving financing from proceeds such as Qualified Mortgage Bond Proceeds. These restrictions require, among other things, and subject to certain exceptions contained in the Federal Tax Code, that borrowers (i) not have had a present ownership interest in their principal residence during the three-year period preceding the extension of financing, (ii) are eligible to finance the purchase of residences with purchase prices not in excess of limits stated in the Federal Tax Code, (iii) must not have family incomes in excess of limits stated in the Federal Tax Code, (iv) may not use the proceeds of the financing to refinance an existing mortgage loan and (v) may use the proceeds of the financing only to finance one-family or one-to-four family dwelling units meeting certain criteria. The Federal Tax Code includes certain procedures that an issuer of Qualified Mortgage Bonds may undertake to satisfy these requirements but requires that 95% or more of the proceeds of the issue be used in full compliance with the loan eligibility restrictions.

Since the number and value of (a) Contracts of Purchase relating to farms and mobile homes, and Contracts of Purchase financed pursuant to the 1943 Act are statistically insignificant, the discussion below is limited to Contracts of Purchase financed under the 1974 Act for homes, excluding farms and mobile homes, unless otherwise indicated. See Exhibit 2—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase."

*Origination.* The Veterans Code, in most cases, requires a veteran to make an initial payment of at least five percent of the selling price of the property, except that where the purchase price is $60,000 or less, the initial payment must be at least three percent of the selling price of the property. Legislation has been introduced to modify the initial payment requirement to more closely resemble those of the USDVA guaranty program. The balance of the purchase price (including USDVA guaranty fees) may be amortized over a period fixed by the Department, not exceeding 30 years and 32 days for all Contracts of Purchase guaranteed by USDVA and 40 years for any other Contracts of Purchase for single-family homes. Nearly all existing Contracts of Purchase are for a term of 30 years. It is the present policy of the Department to limit the term of Contracts of Purchase to a maximum of 30 years. The Department has extended the terms of a small number of Contracts of Purchase beyond 30 years under hardship conditions.

The Veterans Code permits the Department to finance home and property improvements for veterans with existing Contracts of Purchase. Each veteran receiving financing for home and property improvements executes an additional Contract of Purchase with respect to such financing. The additional Contract of Purchase requires payment of the financed amount, bears interest at the same rate as the existing Contract of Purchase on the property, and is payable over a maximum term which is based upon the principal amount financed. In no event can the final payment date for any such additional Contract of Purchase be more than 40 years from the origination of the existing Contract of Purchase. The maximum home improvement loan for those veterans who qualify only for Qualified Mortgage Bond Proceeds is $15,000 over the term of the Contract of Purchase. Home improvement loans funded with Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds are available up to a maximum of $50,000. Subsequent home improvement loans may be granted, if funds are available, so long as there is only one outstanding home improvement loan to such veteran outstanding at any time.

Contracts of Purchase for the purchase of a building site and construction of a home are available. Qualifying sites include undeveloped sites/acreage, lots in subdivision developments, and sites in non-profit self-help developments. Mobile homes in parks do not qualify. Construction of the improvements must be performed by a licensed California contractor. The Department will not submit Contracts of Purchase which finance home construction for USDVA guaranty, although it will charge a "self-insurance" fee for such Contracts of Purchase equal to the applicable USDVA loan guaranty fee. Once the construction is completed, however, the Department expects to submit such Contracts of Purchase for USDVA guaranty.

The Department also limits availability of financing to veterans on the basis of their personal credit status. The Department's current lending criteria conform to those of the USDVA for participation in the USDVA guaranty program for all Contracts of Purchase, including those not eligible for USDVA guaranties.

Department procedures will be consistent with those established by USDVA for its loan guaranty program. The current USDVA maximum maturity for a loan is 30 years and 32 days.

*Servicing.* Late penalty charges are applied to Contracts of Purchase that have a remaining amount due of $25 or more at the close of any account month (usually the 18th day of the month). A $10 penalty late charge is imposed on Contracts of Purchase originated before October 1984. Contracts of Purchase originated during and after October 1984 are subject to a late penalty charge of 5.5% of the principal and interest portion of the installment, in addition to the interest which continues to accrue. The Department's late penalty fees after March 1, 1998 will be consistent with those authorized by USDVA.

The Department may, in any individual case and for good cause, permit the postponement from time to time, and upon such terms as it deems proper, of the payment of the whole or any part of any installment. Contracts of Purchase may also have terms in excess of 30 years if home improvement loans have been obtained, as discussed above. The terms of Contracts of Purchase guaranteed by USDVA cannot exceed 30 years and 32 days.

The Department is finalizing a contract with Leader Mortgage ("Leader") under which Leader will provide loan servicing, including impound accounting and USDVA reporting, for all Contracts of Purchase originated on or after March 1, 1998. Pursuant to such contract, Leader will service Contracts of Purchase until such time as the Department's new integrated mortgage bond finance information system is operational.

*Prepayments.* The Department currently imposes on Contracts of Purchase a prepayment charge of 2% of the purchase price to the veteran if the Contract of Purchase is paid in full within two years of its origination date. After the two-year period, the veteran may prepay without charge any or all installments still remaining unpaid. In order to conform to USDVA guaranty program requirements, the Department will eliminate this prepayment charge by March 1, 1998 for all Contracts of Purchase after that date.

*Cancellations and Delinquencies.* The Department's policies regarding delinquencies and cancellations, beginning March 1, 1998, will conform to USDVA loan guaranty program requirements. In the event of a failure to comply with any of the terms of a Contract of Purchase, the Department may cancel the Contract of Purchase and be released from all obligations, at law or in equity, to convey the property. In such event, the veteran's rights under the Contract of Purchase may be forfeited and all payments made by the veteran prior to termination of the Contract of Purchase deemed to be rental paid for occupancy. Upon such forfeiture, the Department takes possession of the property covered by the Contract of Purchase and resells it. All proceeds from a sale are first applied to pay any bonds used with respect to the repossessed property, with any excess deposited in the 1943 Fund.

If a veteran does not make a payment by the close of the account month in which the payment is due (usually the 18th day of the month), the payment is considered "delinquent." A warning letter is issued on the 20th day of the same account month which advises the veteran that the account is delinquent. Department personnel initiate telephone contact with veterans with delinquent accounts. If the account remains delinquent through the second account month, a Notice of Intent to Cancel Contract is issued at the beginning of the third account month giving notice that the Contract of Purchase may be cancelled at the end of the 30-day notice period unless the account is brought current. A schedule for liquidation of delinquent payments satisfactory to the

Department is arranged during this period; *however,* if the account remains delinquent after such 30-day period and no schedule for liquidation of delinquent payments has been agreed upon, the Department may begin cancellation of the Contract of Purchase. The Department's headquarters Central Collections Unit monitors the delinquency throughout this process, orders a title search to identify any junior lienholders and forwards the pertinent information to the Department's Foreclosure Unit for further precancellation processing in accordance with the California Code of Regulations, Title 12, Section 344, Military and Veterans Affairs. Junior lienholders are identified and sent notices giving them 30 days (40 days in the case of federal tax liens) to protect their interest by beginning foreclosure proceedings. If the account is not brought current during such notice period to junior lienholders and no junior lienholder proceeds with a foreclosure action to protect its interest, the Department's Foreclosure Unit cancels the contract, and a Notice of Cancellation is mailed to the veteran and recorded. The Department's Foreclosure Unit then takes steps to evict occupants and clear any remaining liens. If judicial action is required, the case is referred to the Department's Law Division for additional processing.

After all remaining liens are removed and the property is vacant, the repossessed property is repaired and improved and is marketed through the Department's applicable field office. The Department is required to advertise and accept sealed offers after a 2-week period, and the property is sold to the highest acceptable bidder. If no acceptable bids are received, the property is sold through a real estate broker and a commission of between 3% to 6% of the selling price is paid.

Federal law provides certain protections to military personnel on active duty or reservists ordered to report for military service under The Soldiers' and Sailors' Civil Relief Act of 1940, as amended. If a veteran obtained a Contract of Purchase prior to the relevant period of military service, then during the period of military service the interest rate on the Contract of Purchase cannot exceed 6% (unless the ability of the veteran to pay interest in excess of 6% is not materially impaired by such military service). Also, the veteran may seek a stay (or a court may on its own motion grant a stay) of any court action or proceeding.

See Exhibit 2—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Cancellations and Delinquencies" for additional information regarding the status of Contracts of Purchase.

*Interest Rates.* At present, veterans are charged interest on their Contracts of Purchase at a rate which is set at least annually by the Department, with the review of the Board and the Veterans' Finance Committee of 1943. Most Contracts of Purchase currently bear interest at a rate of 8.0%, although, as discussed under "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES," the Department will lower the interest rate to 6.95% effective April 1, 1998 for 98% of the prior Contracts of Purchase and all of the newly originated Contracts of Purchase being financed currently. The Veterans Code currently requires that all Contracts of Purchase bear the same interest rate. In accordance with the current provisions of the Veterans Code, the interest rate for Contracts of Purchase can be changed at any time and as often as necessary. The effective date of a higher rate of interest on Contracts of Purchase may occur only once in any calendar year unless a finding is made by the Board and the Veterans' Finance Committee of 1943 that such additional action is necessary to protect the solvency of the 1943 Fund.

Legislation has been introduced which (i) will eliminate the uniform interest rates requirement for future Contracts of Purchase and (ii) will allow the Department to establish fixed interest rates for such Contracts of Purchase. See "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES."

**Loan Insurance**

As discussed above under "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES," the Department is completing several programmatic changes, including obtaining loan insurance from private primary mortgage insurers for certain existing Contracts of Purchase with high loan-to-value ratios and USDVA guarantees for new Contracts of Purchase with high loan-to-value ratios.

*USDVA Guaranty Program.* The Department has been approved by the USDVA as an originator of loans eligible to receive a guaranty from the USDVA. As a result, effective March 1, 1998, the Department expects to originate each future Contract of Purchase with a loan-to-value ratio of 80% or higher with a USDVA guaranty, if such Contract of Purchase is otherwise eligible for USDVA guaranty.

The Servicemen's Readjustment Act of 1944, as amended, permits a veteran (or in certain instances the veteran's spouse) to obtain a mortgage loan guaranty from USDVA covering mortgage financing of the purchase or construction of a one-to-four family dwelling unit at interest rates permitted by USDVA. The USDVA program has no preset mortgage loan limits and permits the guaranty of mortgage loans of up to 30 years and thirty-two days' duration. While the USDVA program does not require a down payment from the purchaser, the Veterans Code currently requires down payments, although the Department is seeking legislative changes to modify this requirement. Under the USDVA program, the maximum USDVA guaranty on a loan is the lesser of the veteran's available entitlement (a maximum of $36,000, or if the original loan amount exceeds $144,000, a maximum of $50,750), or (1) 50% of the original loan amount if such amount does not exceed $45,000, (2) $22,500 if the original loan amount is between $45,000 and $56,250, (3) the lesser of $36,000 or 40% of the original loan amount, if such amount is between $56,250 and $144,000, or (4) the lesser of $50,750 or 25% of the original loan amount, if such amount is in excess of $144,000. The liability on the guaranty is reduced or increased pro rata with any reduction or increase in the amount of indebtedness, but in no event will the amount payable on the guaranty exceed the amount of the original guaranty. Notwithstanding the dollar and per centum limitations of the guaranty, a mortgage holder will ordinarily suffer a monetary loss only where the difference between the unsatisfied indebtedness and the proceeds of a foreclosure sale of a mortgaged property is greater than the original guaranty as adjusted. Extended periods without interest payments prior to foreclosure will also increase the potential for losses. In the event of a default in the payment of a USDVA loan, but prior to a suit or foreclosure, USDVA may, at its option, pay to a mortgage holder the unpaid balance of the obligation plus accrued interest and receive an assignment of the loan and security.

*Self Insurance Mortgage Loss Set-Aside.* The Department has established a mortgage loss fund within the 1943 Fund to be funded by mortgage insurance charges paid by veteran recipients of Contracts of Purchase that do not qualify for USDVA guaranties or that have loan amounts that exceed USDVA coverage.

*Primary Mortgage Insurance.* The Department is finalizing a contract with CMAC to provide primary mortgage insurance with respect to certain existing Contracts of Purchase with loan-to-value ratios of 80% or higher. Such primary mortgage insurance will cover aggregate actual losses following property disposition above a 3.0% self-insured level. The Department is finalizing the purchase of such insurance which, when the applicable contract is executed, is expected to retroactively cover losses incurred on or after February 1, 1998.

**Property and Life and Disability Insurance**

The Veterans Code and/or long-standing Department policy have called for a veteran to maintain certain insurance with respect to the property covered by a Contract of Purchase. Insurance must be in the amount and under the conditions specified by the Department, and is either provided by the Department or by insurance companies selected by the Department.

*Fire and Hazard Coverage.* The Department self-insures for fire and hazard losses, using the 1943 Fund to make payments, up to a deductible. The Master Policy described below (the "Master Policy") provides coverage in excess of the deductible, except that the Master Policy does not cover mobile homes, condominiums or planned unit development properties covered by blanket insurance policies provided by homeowners' associations. The Master Policy is provided by a commercial insurer.

Under each Contract of Purchase, the veteran is required to pay the sum charged to his or her account to cover costs of providing the insurance coverage including the insurance premium due under the Master Policy described below with respect to his or her property. From the amount charged to each veteran, the Department retains a portion to provide the sums necessary to pay all losses up to $1,500,000 per occurrence or $12,000,000 per policy year. If the total losses from a single occurrence exceed $1,500,000 or if the aggregate of all fire and hazard insurance losses for a policy year exceed $12,000,000, liability for the excess will be covered under the Master Policy. The Master Policy will expire on October 31, 1998.

The Master Policy is an all-physical loss form. Fire and hazard insurance coverage for participants in the Program is adjusted annually to reflect increasing building costs and is maintained on a guaranteed replacement cost basis for homes and on an actual cash value basis for outbuildings. A $250 deductible payable by the veteran applies to each loss. Claims must be submitted within 12 months of loss. Each veteran with a Contract of Purchase pays an annual insurance premium equal to $1.22 per $100 of insured value which is prorated and included in the veteran's monthly installment. Claims adjustments and payments are made on behalf of the Department and the provider of the Master Policy by an affiliate of such provider.

*Disaster Indemnity Plan.* The Department provides certain disaster indemnity and catastrophe real property insurance ("Disaster Indemnity Plan"). Neither such insurance nor the indemnity fund described below are payable from or a part of the 1943 Fund. The Disaster Indemnity Plan indemnifies participants against the cost of repairing damage in excess of a deductible caused by flood, earthquake or other perils not covered by the fire and hazard insurance policy (not otherwise excluded). The deductible for flood losses is $500 and the deductible for earthquake losses is $500 or 5% of the amount of loss, whichever is higher. The catastrophe insurance has been obtained from a consortium of nineteen insurance companies for a total of $50,000,000 of coverage with a $4,000,000 annual deductible. The 1997 to 1998 annual premium for this coverage is $2,735,175.

Each veteran in the Program participates in the Disaster Indemnity Plan and pays his or her pro rata share of the annual premium. Such payments are deposited in an indemnity fund created in the Treasury of the State to be utilized to pay the deductible discussed above. Each veteran pays an initial assessment of $1.35 per $1,000 of insured value, and any assessments as may be required to sustain the indemnity fund. The value of the indemnity fund as of June 30, 1997 was $10,525,000.

Effective December 1, 1997, the Department has purchased individual flood policies through the Federal Emergency Management Agency (FEMA) covering all properties financed by Contracts of Purchase that are located in designated flood zones.

*Life and Disability Coverage.* In the past, the Department self-insured from the 1943 Fund life and disability coverage for veterans with Contracts of Purchase. Following a period of significant and recurring losses incurred by the 1943 Fund (see "SELECTED FINANCIAL DATA OF

THE 1943 FUND AND DEPARTMENT'S DISCUSSION"), the Department effective June 1, 1996, replaced most of the Department's self-insured life and disability insurance program by a life and disability insurance plan (the "Life and Disability Plan") provided by PM Group Life Insurance Company ("PM Group"). The Department continues to self-insure those veterans who were already receiving disability benefits at the time the Life and Disability Plan was implemented. Benefits are equal to the amount of the monthly loan payment at the time of their disability. Those benefits will continue under the provisions of the self-insured plan until the beneficiary returns to active employment, dies, or his contract is paid off. Loss reserves for these obligations have been actuarially determined. A portion of the required loss reserves are maintained under a third party administrator agreement and are shown in the financial statements for the 1943 Fund as investments with insurance administrators. The remaining amount is unfunded, but reserved in the form of a loss against retained earnings. See "SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION."

Effective February 1, 1998, the Department implemented a new life and disability protection plan which is provided by PM Group. All holders of Contracts of Purchase who had life and disability coverage under the prior plan were transferred automatically to the new plan. Major elements of the life and disability coverage will continue unchanged for all currently insured up to age 60. For formerly insured holders of Contracts of Purchase under age 60, 100% of the loan balance is covered. Life insurance coverages at subsidized rates for those currently insured contract holders in the program over age 60 are limited to a maximum of the loan amount or $75,000, if less, reducing in increments every 5 years to a maximum of $5,000 after age 80. Such Contract holders can obtain, at actuarial rates, full coverage. Holders of new Contracts of Purchase will be covered under a new insurance plan. It will continue to require life insurance coverage but in an amount sufficient to cover home payments for five, three or one year(s) depending on the health of the individual loan applicant. All new loan applicants must apply and must be provided the minimum life insurance coverage. Disability coverage, for a period up to two years, will be optional for new loanholders, but is a mandatory requirement for existing Contract of Purchase holders. The disability insurance benefit provides home loan protection by paying the participant's monthly loan installment (including insurance premiums) for a maximum benefit period of two years per disability, unless due to a psychiatric condition which would then limit the maximum benefit period to 12 months. Additional, full coverage, life insurance may also be purchased as an option by new contract holders. Spouse life insurance coverage is available as an option. The new plan is an experience rate plan subject to annual rating reviews of insurance claims, expenses, risk charges, profits and premiums. In addition to the new insurance coverages, the Department has established a one-time $5 million rate stabilization reserve, which the Department will retain as part of the 1943 Fund.

## THE 1943 FUND

### General

The components of the 1943 Fund are (i) proceeds derived from the sale of Revenue Bonds, (ii) the proceeds of Veterans G.O. Bonds, (iii) amounts receivable under all Contracts of Purchase and from sales of properties subject to cancelled Contracts of Purchase, (iv) temporary investments, cash and funds, and (v) other miscellaneous assets. Proceeds of Veterans G.O. Bonds may not be applied to payment of principal of, and interest and any redemption premium on, the Revenue Bonds. The holders of Revenue Bonds are not entitled to compel the sale of Contracts of Purchase and the properties to which they relate, but are entitled to receive payment out of the Revenues derived from those Contracts of Purchase and properties, subject to the prior claims, if any, of the Veterans G.O. Bonds.

In addition to payment or reimbursement of debt service on the Veterans G.O. Bonds and Revenue Bonds, as described below, moneys in the 1943 Fund are used to pay administrative costs of the Department, and to fund certain losses from and reserves for property insurance and life and disability insurance described above under "THE PROGRAM—Property and Life and Disability Insurance."

The Program has experienced significant losses during the last five fiscal years, which have caused decreases in the retained earnings in the 1943 Fund. For additional information, see below "SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION" and also see Exhibit 1—"DEPARTMENT AUDITED FINANCIAL STATEMENTS."

The Act and the Veterans Code provide that the undivided interest created by the Resolution in favor of the holders of Revenue Bonds in the assets of the 1943 Fund is secondary and subordinate to the interest of the people of the State and the holders of Veterans G.O. Bonds. Moneys in the 1943 Fund must be paid, on the debt service payment dates of Veterans G.O. Bonds, to the General Fund in the amount of the principal of (whether at maturity or upon redemption or acceleration), and premium and interest on Veterans G.O. Bonds then due and payable (other than debt service payable from the proceeds of refunding bonds). If amounts in the 1943 Fund are insufficient for such purposes, the General Fund will pay debt service on Veterans G.O. Bonds. The balance remaining unpaid must be transferred to the General Fund out of the 1943 Fund as soon thereafter as it becomes available, together with interest thereon at the rate borne by the Veterans G.O. Bonds, compounded semiannually. Until such amounts are repaid to the General Fund, no payments may be made on the Revenue Bonds other than from amounts then in the Bond Reserve Account and the Loan Loss Account. These rights with respect to the 1943 Fund do not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds.

As of February 2, 1998, there were outstanding $2,876,400,000 aggregate principal amount of Veterans G.O. Bonds and $120,990,000 aggregate principal amount of Revenue Bonds. $154,065,000 of Revenue Bonds have been sold by the Department and are scheduled to be issued on May 5, 1998. As of February 2, 1998, $301,500,000 of Veterans G.O. Bonds were authorized but not issued, and the Department may in the future seek voter approval for additional amounts of Veterans G.O. Bonds. The Offered Veterans G.O. Bonds will use $124,665,000 of such authorized amount. Under the Act, Revenue Bonds in an aggregate principal amount not to exceed $1,500,000,000, at any given time, may be outstanding. The Legislature may increase the amount of Revenue Bonds issuable under the Act or may decrease such amount to an amount not less than the amount of Revenue Bonds then outstanding. See "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES" for information about the issuance of the Offered Veterans G.O. Bonds and the retirement of outstanding Veterans G.O. Bonds and Revenue Bonds. Additional information about outstanding Veterans G.O. Bonds and Revenue Bonds is in Exhibit 2—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Veterans G.O. Bonds and Revenue Bonds."

Current provisions of the Veterans Code require that the interest rate on all Contracts of Purchase (except certain *de minimis* exceptions) be uniform and that the Department establish and periodically adjust interest rates on Contracts of Purchase sufficient to, among other things, maintain the solvency of the 1943 Fund. Legislative changes have been introduced which (i) will eliminate the uniform interest rate requirements for Contracts of Purchase, and (ii) will allow the Department to establish fixed interest rates for such Contracts of Purchase. The earliest effective date of such legislation is likely to be January 1, 1999. There is no assurance that such legislation will be enacted, but if enacted, the requirements that the interest rates on all Contracts of Purchase must be uniform and periodically adjusted will no longer apply.

See "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES" for a discussion of the Department's plan to reduce the interest rates on existing Contracts of Purchase. For additional information regarding the existing interest rates of and setting interest rates on Contracts of Purchase, see "THE PROGRAM—Contracts of Purchase" and Exhibit 2—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase."

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## SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION

### Selected Financial Data of the 1943 Fund

The following selected financial data of the 1943 Fund for fiscal years ended June 30, 1997 and 1996 has been derived from the financial statements of the 1943 Fund audited by Deloitte & Touche LLP, independent auditors, whose report thereon appears in Exhibit 1 to Appendix B in this Official Statement. The following selected financial data of the 1943 Fund for fiscal years ended June 30, 1995, 1994 and 1993 has also been derived from the audited financial statements of the 1943 Fund which are not included herein. This selected financial data should be read in conjunction with the financial statements and notes thereto of the 1943 Fund contained in said Exhibit 1 and the Department's Discussion of Financial Data contained herein.

**SELECTED FINANCIAL DATA OF THE 1943 FUND**
**(Thousands of Dollars)**

| | June 30, 1997 | June 30, 1996 | June 30, 1995 | June 30, 1994 | June 30, 1993 |
|---|---|---|---|---|---|
| | Income Statement Items | | | | |
| *NET INCOME (EXPENSE) FROM LENDING AND FINANCING ACTIVITIES* | | | | | |
| INTEREST INCOME | | | | | |
| Interest on Contracts | $ 175,186 | $ 182,636 | $ 181,595 | $ 185,040 | $ 204,813 |
| Interest on Investments | 67,373 | 79,510 | 76,846 | 83,153 | 86,734 |
| Transfers of Interest from Veterans Debenture Revenue Fund | 10,843 | 11,144 | 11,164 | 11,031 | 11,131 |
| Total | 253,402 | 273,290 | 269,605 | 279,224 | 302,678 |
| BOND INTEREST EXPENSE | (230,871) | (245,971) | (252,792) | (274,271) | (309,629) |
| *Net Interest Income (Expense)* | **22,531** | **27,319** | **16,813** | **4,953** | **(6,951)** |
| CONTRACTS OF PURCHASE | | | | | |
| Net Loss on Sale of REO's | (8,309) | (5,510) | (2,200) | (945) | (160) |
| Provision to Increase the Allowance for Contract Losses | (22,677) | (5,515) | (10,463) | (10,837) | (1,800) |
| Total | (30,986) | (11,025) | (12,663) | (11,782) | (1,960) |
| *Net Lending And Financing Activities Income (Expense)* | (8,455) | 16,294 | 4,150 | (6,829) | (8,911) |
| *NET EXPENSE FROM ADMINISTRATIVE ACTIVITIES* | | | | | |
| Operating Revenue | 2,290 | 1,769 | 2,768 | 1,617 | 2,062 |
| Operating Expenses | (20,218) | (18,810) | (17,675) | (18,973) | (19,018) |
| *Net Administrative Activities Expense* | **(17,928)** | **(17,041)** | **(14,907)** | **(17,356)** | **(16,956)** |
| *NET INCOME (EXPENSE) FROM INSURANCE ACTIVITIES* | | | | | |
| Life and Disability Coverage | 3,570 | (5,424) | (13,781) | (1,152) | (16,016) |
| Fire and Hazard Coverage | 326 | (538) | (4,202) | 3,809 | (3,648) |
| *Net Insurance Activities Income (Expense)* | **3,896** | **(5,692)** | **(17,983)** | **(2,657)** | **(19,664)** |
| TOTAL DEFICIENCY OF REVENUES AND TRANSFERS OVER EXPENSES | (22,487) | (6,709) | (28,740) | (21,528) | (45,531) |
| RETAINED EARNINGS | $ 258,153 | $ 280,640 | $ 287,349 | $ 316,089 | $ 337,617 |

# SELECTED FINANCIAL DATA OF THE 1943 FUND
## (Thousands of Dollars)*

| | June 30, 1997 | June 30, 1996 | June 30, 1995 | June 30, 1994 | June 30, 1993 |
|---|---|---|---|---|---|
| | | | Balance Sheet Items | | |
| ***ASSETS AND LIABILITIES—LENDING AND FINANCING ACTIVITIES*** | | | | | |
| CASH AND INVESTMENTS | | | | | |
| Cash and amounts on Deposit in SMIF | $ 317,178 | $ 295,140 | $ 306,269 | $ 1,058,832 | $ 1,193,472 |
| Guaranteed Investment Contracts | 365,542 | 475,744 | 591,449 | 326,638 | 360,493 |
| Treasury Securities | 332,760 | 355,900 | 378,628 | 54,150 | 55,472 |
| Total | 1,015,480 | 1,126,784 | 1,276,346 | 1,439,620 | 1,609,437 |
| DUE FROM VETERANS DEBENTURE REVENUE FUND | 86,279 | 137,141 | 137,166 | 137,108 | 137,221 |
| OTHER CURRENT ASSETS | 22,596 | 26,191 | 25,787 | 24,819 | 39,667 |
| NET OTHER NON-CURRENT ASSETS | 15,123 | 15,824 | 16,600 | 13,255 | 14,888 |
| CONTRACTS OF PURCHASE | | | | | |
| Performing Contracts | 2,154,142 | 2,231,994 | 2,356,818 | 2,185,107 | 2,499,994 |
| REO Contracts at Carrying Value | 75,038 | 74,268 | 53,257 | 40,619 | 32,300 |
| Total | 2,229,180 | 2,306,262 | 2,410,075 | 2,225,726 | 2,532,294 |
| Allowance for Uncollectable Contracts | (26,412) | (15,801) | (15,066) | (16,937) | (6,100) |
| Markdown of REO to Fair Value | (24,003) | (17,113) | (12,334) | 0 | 0 |
| Total | (50,415) | (32,914) | (27,400) | (16,937) | (6,100) |
| BONDS PAYABLE | | | | | |
| General Obligation Bonds | (2,632,045) | (2,812,810) | (3,002,695) | (2,802,260) | (3,015,850) |
| Revenue Bonds | (327,580) | (374,975) | (434,545) | (600,890) | (853,495) |
| Total | (2,959,625) | (3,187,785) | (3,437,240) | (3,403,150) | (3,869,345) |
| ACCRUED INTEREST AND OTHER CURRENT LIABILITIES | (80,502) | (86,716) | (90,868) | (96,821) | (104,371) |
| ***Net Lending and Financing Assets*** | **278,116** | **304,787** | **310,466** | **323,620** | **353,691** |
| ***ASSETS AND LIABILITIES—INSURANCE ACTIVITIES*** | | | | | |
| LIFE AND DISABILITY COVERAGE | | | | | |
| Deposits with Insurance Administrators | 47,270 | 56,843 | 61,625 | 63,892 | 63,932 |
| Insurance Reserves and Claims Payable | (65,828) | (78,246) | (79,729) | (68,214) | (74,140) |
| Total | (18,558) | (21,403) | (18,104) | (4,322) | (10,208) |
| FIRE AND HAZARD COVERAGE | | | | | |
| Net Deposit with Insurance Administrators and Insurance Reserves and Claims Payable | (1,405) | (2,744) | (5,013) | (3,209) | (5,866) |
| ***Net Insurance Liabilities*** | **(19,963)** | **(24,147)** | **(23,117)** | **(7,531)** | **(16,074)** |
| RETAINED EARNINGS | $ 258,153 | $ 280,640 | $ 287,349 | $ 316,089 | $ 337,617 |
| SUMMARY INFORMATION | | | | | |
| Total Assets | $ 3,361,050 | $ 3,631,714 | $ 3,895,818 | $ 3,887,151 | $ 4,390,288 |
| Total Liabilities | $ 3,102,897 | $ 3,351,074 | $ 3,608,469 | $ 3,571,062 | $ 4,052,671 |
| Total Number of Contracts of Purchase | 39,343 | 42,650 | 47,075 | 48,341 | 57,992 |

*Except for Total Number of Contracts of Purchase

**Department's Discussion of Financial Data**

The 1943 Fund, which is the sole operating fund for the Program, reflects a retained earnings balance of $258,153,000 as of June 30, 1997. This balance has decreased approximately 32.6 percent since year-end FY 1992 when it peaked at $383,148,000. While retained earnings have decreased in recent years, the overall asset-to-liability ratio for the 1943 Fund has remained nearly constant at approximately 108.0 during the same period. The total deficiency of revenues for the Program for FY 1997 was $22,487,000 compared to $6,709,000 in FY 1996. The aggregate deficiency of revenues for the Program during the five-year period reflected in the tables above was $124,995,000.

As further described below, the Program has experienced significant losses during the last five years for three principal reasons: (i) a low interest rate environment that produced higher prepayment levels and decreased investment earnings on bond proceeds and other invested funds in the 1943 Fund during FY 1993 and FY 1994; (ii) financial losses associated with the Department's self-insured life and disability and property insurance programs during FY 1993 through FY 1996; and (iii) losses on sale of repossessed properties and allowances for losses associated with the Department's portfolio of Contracts of Purchase during FY 1994 through FY 1997. However, as discussed below, the Department has recently undertaken major initiatives to address each of these areas and expects such actions to have a positive impact on future years' financial performance.

The Program's FY 1997 net interest income (total interest income less bond interest expense) of $22,531,000 was $4,788,000 less than FY 1996. This decrease was attributable to net adjustments of $4,968,000 to FY 1996 net interest income for previously unrecorded investment interest and over-accrual of bond interest expense. Accordingly, FY 1997 net interest income reflected an increase of $180,000 compared to the FY 1996 amount before adjustment, despite a continued decline in the principal balance of outstanding Contracts of Purchase and invested funds. As a result, net interest margin (net interest income divided by interest bearing assets) increased from 0.63% in FY 1996 (before adjustment) to 0.68% in FY 1997. These results compare favorably to those of the earlier years represented in the table above and reflect the Department's continuing efforts over the last several years to reduce debt service cost and increase interest income. These efforts have included, where possible, redemption of outstanding higher interest rate bonds prior to maturity and the transfer of certain invested funds from lower yielding variable rate instruments to higher yielding fixed rate investments. Notwithstanding these recent actions, the Department's future net interest income will continue to be adversely affected by $870,955,000 (as of December 31, 1997) of outstanding non-callable Veterans G.O. Bonds with an average interest cost of approximately 9.00% which cannot be fully retired before the year 2010 (See Exhibit 2—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Veterans G.O. Bonds and Prior Revenue Bonds").

Like all loan portfolios, the Program experienced fluctuating levels of prepayments and new originations of Contracts of Purchase primarily influenced by the rates of interest of conventional mortgage financing relative to the Program's interest rates (either 8.00% or 7.75% during the period reflected in the table above). The net effect of these factors resulted in the outstanding principal balance of Contracts of Purchase declining 12.0% since June 30, 1993. (See Exhibit 2—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA" for detailed information regarding the history of repayments, prepayments and originations of Contracts of Purchase.) During the same period, cash and invested funds dropped 36.9% due primarily to the use of such assets to pay bond maturities or redeem bonds and fund new Contracts of Purchase. In aggregate, total Program assets have declined 23.4% since June 30, 1993. The debt structure of the Program, however, accommodated this downward trend in assets through a series of bond redemptions which resulted in a nearly equivalent reduction in the bonds outstanding.

Due to the decline in real estate values in certain California housing sub-markets in the early 1990's and the concentration of the Department's Contract of Purchase portfolio in certain areas of the State which were economically depressed due to military base closures and defense industry employment reductions, the number of repossessed properties (REOs) and their loss on sale have both increased significantly since FY 1994. The principal balance of Contracts of Purchase classified as REO increased from $14,395,000 at June 30, 1992 to $75,038,000 at June 30, 1997. Aggregate net losses on sales of REOs increased sharply beginning in FY 1995 and totalled $17,124,000 from FY 1993 through FY 1997, representing 0.77% of the total principal amount of Contracts of Purchase outstanding at June 30, 1997. During FY 1996 and FY 1997, the Department moved aggressively to repossess properties of cancelled Contracts of Purchase and to dispose of its REOs. Losses resulting from such increased REO disposition efforts were compounded by the negative real estate market factors cited above, causing the Department to reassess the adequacy of its loan loss allowance. Accordingly, the Department's allowance for loan losses was increased by two-thirds in FY 1997 compared to FY 1996. This loan loss allowance increase, together with reductions in the estimated disposition value of its current REO portfolio, has resulted in a cumulative net charge to operations of $50,415,000 to provide for potential losses in the portfolio. These actions, together with the Department's plan to obtain primary mortgage insurance with respect to certain existing Contracts of Purchase with high loan-to-value ratios (see "THE PROGRAM—Loan Insurance"), are expected to provide for future potential REO losses.

Program administrative operating expenses in FY 1997 increased by $1,408,000, or 7.5%, due in large part to consulting expenses and personnel costs relating to identifying and developing strategies to: improve overall Program operations; procure a state-of-the-art integrated mortgage and finance computer system; and complete conversion of the life and disability insurance program to an outside commercial insurer. After taking into effect a $521,000 increase in operating revenue, net administrative operating expenses increased 5.2% over FY 1996 results.

Effective June 1, 1996, the Department's self-insured life and disability coverage plan was transferred to a fully-insured plan underwritten by an outside commercial insurer except for that portion of the program covering existing claims of disabled contract holders for whom the Department continues to provide coverage. Loss reserves for these obligations have been actuarially determined. More than two-thirds of such loss reserves are funded and maintained under a third party administrator agreement. The remaining amount is unfunded, but reserved in the form of an accrued liability. The net effect of these changes resulted in the plan operating on a break-even basis in FY 1997 compared to aggregate losses of $36,373,000 over the four prior fiscal years.

Effective November 1, 1996, a number of changes were made to the Department's fire and hazard insurance coverage, including increasing the deductible, eliminating outdated loss coverages and limiting the claims period. These changes have resulted in stabilized financial operations for the Department's fire and hazard coverage over the last two fiscal years.

Further financial information relating to the 1943 Fund can be located in Exhibit 1 to Appendix B in this Official Statement.

**LAO Report**

The Legislative Analyst's Office for the State of California (the "LAO"), on January 16, 1998, issued a report entitled "Rethinking the Cal-Vet Loan Program" (the "LAO Report"). The stated purpose of the LAO is to provide analysis and nonpartisan advice to the California Legislature on fiscal and policy issues. The LAO is overseen by the Joint Legislative Budget Committee, a 14-member bipartisan committee composed of an equal number of State Assembly and State Senate members.

In the LAO Report, the LAO analyzes the historical and recent financial performance and lending activities of the Department and makes various recommendations. The LAO Report describes the financial losses experienced by the Department and the decreased lending activity in recent years. It attributes the decreased lending activity principally to more attractive loan programs available from other sources and to a dwindling population of eligible veterans. The LAO Report states that the Department's completed and proposed programmatic changes (including changing from the uniform interest rate) and the Department's bond restructuring program, implemented with the sale of over $1.4 billion of Veterans G.O. Bonds and Revenue Bonds in December 1997 and including the issuance of the Offered Veterans G.O. Bonds, are reasonable overall. However, its analysis of the interests of the State and of the future needs of veterans and funding sources has led to several recommendations, which include increased oversight of the Department, ending new loan origination after the year 2007, and use of "surplus" Department moneys to fund other benefits for veterans. The LAO Report states that any redirection of "surplus funds should be accomplished carefully by means that ensure that all obligations of the [S]tate to Bondholders are met." Any further actions on the LAO Report would result from legislative changes that would be proposed by the Legislature and signed by the Governor. In addition, any such use of surplus funds may have to be authorized through a ballot measure.

The Veterans Affairs Committee of the State Senate, which is charged with oversight of the Department for the State Senate, held hearings on the LAO Report on February 10, 1998. No further action, including legislation or additional hearings, was proposed by the Senate Veterans Affairs Committee at the end of such hearings. The Assembly Select Committee on Veterans Affairs held a hearing where, although the proposals contained in the LAO Report were an agenda item, the LAO Report was not addressed. The Committee Chair has announced that a new hearing will be scheduled, although the agenda for that meeting has not been established. Although none have been announced to date, and the Department has no information that any are under consideration, future hearings could be held by other parts of the Legislature, and legislation addressing some or all of the matters raised in the LAO Report could be introduced by any member of the Legislature.

The financial performance of and loan origination by the Department, and its proposed programmatic changes, have been discussed elsewhere in this Official Statement. While the Department does not agree with the LAO recommendations to terminate loan originations after 2007 and to use Department moneys to fund other programs, it does not believe that either such event will have an adverse impact on the Department's ability to pay scheduled principal and interest on any Veterans G.O. Bonds or Revenue Bonds. While the Legislature could enact any or all of the recommendations in the LAO Report, use of moneys in the 1943 Fund for other veterans benefits as proposed in the LAO Report may be subject to approval by the electorate of the State and may also be subject to other legal restrictions.

**Litigation**

On June 25, 1996, the Department was served with a summons and complaint initiating a lawsuit entitled *John L. Debbs, et al. v. California Department of Veterans Affairs, et al.* (Superior Court of California, County of Los Angeles, Case No. BC 151476). The third amended complaint alleges "fraudulent concealment, declaratory relief, injunctive relief, and damages for monies unlawfully taken from the California Veterans Farm and Home Life and Disability Protection Plan." Plaintiff claims that in 1983, when the Department cancelled its contracts with two life insurance companies then responsible for underwriting the life and disability programs, over $100 million was illegally expended by the Department, and that certain transfers from the life and disability reserves to the 1943 Fund were unlawful. The complaint seeks, among other things, that premiums under the life and disability program be reduced to prior levels and the return of the moneys, plus interest, from the 1943 Fund to the life and disability reserves. Plaintiff is seeking to convert this action into a class action suit. Plaintiff has sought a preliminary injunction and temporary restraining order from the court in order to prevent the changes to the Department's life and disability program described in this Official Statement. The court denied the temporary restraining order and has advised plaintiff that it will not schedule a hearing based on plaintiff's current motions. .

John L. Debbs and his wife have filed a separate federal court action (entitled *John L. Debbs and Patsy R. Debbs v. Jay Vargas, et al.*) (United States District Court, Eastern District of California, Case No. Civ-S-97-0123) against the Department, the Pacific Mutual Life Insurance Company, several former and current Board members and two Department employees as individuals. The court dismissed the Department, the Department employees, and all of the current Board members as defendants. The only remaining defendants are three former Board members and the Pacific Mutual Life Insurance Company. The claims allege violation of constitutional rights, fraud, misappropriation, conspiracy, violation of equal protection, slander, bad faith, breach of fiduciary duty, "arbitrage violations" and other purported misdeeds. The complaint covers a period of approximately twenty years and requests a restraining order, injunctive relief, a receivership of the 1943 Fund and of the Program, criminal relief and general, compensatory, punitive, prospective, consequential and special damages of over $3,550,000.

On February 19, 1998, John L. Debbs and his wife filed an additional federal court action (entitled *John L. Debbs and Patsy R. Debbs v. Jay Vargas, et al.)* (United States District Court, Eastern District of California, Case No. CIV-S-98-0310) against Department Secretary Jay Vargas, employee Leon Tuttle and the five present Board members (in addition to Secretary Vargas), all of whom are sued in their personal capacities. PM Group and Pacific Mutual Life Insurance Company are also named. The Department is not included in the suit. This federal suit is essentially a repetition of the previously-filed federal suit with a few additional claims. Purported charges range from violation of civil rights, conspiracy, racial discrimination and retaliation, to fraudulent concealment, fraud, bad faith, "arbitrage," conspiracy, breach of fiduciary duty, and "anti-trust Clayton Act violations." This complaint also covers about twenty years of supposed fraud and misdeeds and asks for similar types of damage to what is requested in the earlier federal suit, except that with punitive damages included the amount demanded exceeds $20 million.

The Department is vigorously opposing all of these lawsuits. While the outcome of any litigation cannot be predicted with certainty, the Department expects ultimately to prevail in these matters. Even if the plaintiff should prevail in all of these matters, the Department does not expect such outcome to affect its ability to make timely payment of debt service on the Revenue Bonds.

**Excess Revenues**

The Department has covenanted with the holders of its Revenue Bonds to apply Revenues received with respect to Contracts of Purchase, after payment or reimbursement of debt service on Veterans G.O. Bonds, in a specified order of priority. For this purpose, "Revenues" means all moneys received by or on behalf of the Department representing (i) principal and interest payments on the Contracts of Purchase including all prepayments representing the same and all prepayment premiums or penalties received by or on behalf of the Department in respect to the Contracts of Purchase, (ii) interest earnings received on the investment of amounts to the extent deposited in the revenue account established under the resolution authorizing the issuance of revenue bonds (the "Revenue Bond Resolution"), (iii) amounts transferred to the revenue account from the bond reserve account or the loan loss account established under the Revenue Bond Resolution, and (iv) any other amounts payable by parties executing Contracts of Purchase or private participants in the Program or related to recoveries on defaulted Contracts of Purchase, including origination and commitment fees, servicing acquisition fees, and liquidation/insurance Proceeds, except to the extent not included as "Revenues" pursuant to the provisions of any resolution authorizing the issuance of a series of Revenue Bonds.

The Department has covenanted with the Revenue Bond holders to administer the 1943 Fund and the Program and perform its obligations to such holders in accordance in all material respects with the then-current Program Operating Procedures. The Program Operating Procedures are operating policies of the Department governing the discretionary activities of the Department under the Revenue Bond Resolution. The Department may amend the Program Operating Procedures. The Program Operating Procedures will affect the Excess Revenues that will become available to redeem the Bonds.

The Department has covenanted with the Revenue Bond holders to apply Revenues in the following order, after paying, or reimbursing for payments of, debt service on Veterans G.O. Bonds, including the costs of liquidity and credit enhancement facilities related thereto, and setting aside moneys as required under the Federal Tax Code to preserve the tax-exempt status of certain Veterans G.O. Bonds and Revenue Bonds, (1) to pay debt service on Revenue Bonds, (2) to pay the costs of liquidity and credit enhancement facilities, if any, for Revenue Bonds, (3) to replenish certain reserve funds established for the Revenue Bonds, (4) if the Department elects, to pay Department expenses, (5) to set aside a monthly accrual of Veterans G.O. Bond debt service, (6) if the Department elects, to finance Contracts of Purchase, and (7) with respect to Excess Revenues and certain tax restricted moneys, to redeem Veterans G.O. Bonds, including the Bonds, and Revenue Bonds. For such purposes:

(a) "Excess Revenues" means, as of any date of calculation, Revenues in excess of Accrued Debt Service;

(b) "Accrued Debt Service" means, as of any date of determination and, as the context requires, with respect to all Revenue Bonds and Veterans G.O. Bonds (including the Offered Veterans G.O. Bonds), the sum of:

(i) the aggregate amount of scheduled interest and principal (except to the extent otherwise to be redeemed pursuant to clause (i) or (ii) below) to become due after such date but on or before the end of the current debt service year, less the product of (i) the number of whole months remaining in the current debt service year and (ii) the Monthly Debt Service Requirement;

(ii) the redemption price of bonds for which notice of redemption has been issued, provided such redemption price is to be paid from amounts on deposit in the revenue account created under the Resolution; and

(iii) the redemption price of bonds that the Department will be obligated to redeem prior to the end of the next succeeding debt service year, to the extent that such obligation arises on account of amounts on deposit in such revenue account; and

(c) "Monthly Debt Service Requirement" means, as of any date of determination, one-twelfth of the aggregate amount of scheduled interest and principal to become due during the debt service year in which such date falls, as computed on the first day of such debt service year.

**Maintenance of Fund Parity**

The Revenue Bond Resolution requires the Department to calculate "Fund Parity" at least annually. "Fund Parity" means (a) an amount equal to the difference between (i) all assets in the 1943 Fund and in the accounts established under the Revenue Bond Resolution, and (ii) the principal amount of all Revenue Bonds and Veterans G.O. Bonds outstanding (plus accrued interest) reduced by (b) defined allowances and reserves for loss coverage on Contracts of Purchase and life and disability coverage on persons obligated under Contracts of Purchase. If any such calculation shall not reflect that Fund Parity at least equals the percentage required by the Revenue Bond Resolution, the Department may be required to expend Excess Revenues to redeem Revenue Bonds until its recalculations of Fund Parity meet the test required by the Revenue Bond Resolution.

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DEPARTMENT AUDITED FINANCIAL STATEMENTS

# VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

Financial Statements for the Years Ended June 30, 1997 and 1996 and Independent Auditors' Report

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Deloitte &
Touche LLP

Suite 2000
400 Capitol Mall
Sacramento, California 95814-4424

Telephone: (916) 498-7100
Facsimile: (916) 444-7963

## INDEPENDENT AUDITORS' REPORT

Department of Veterans Affairs
State of California
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California (Fund) as of June 30, 1997 and 1996, and the related statements of revenues, expenses and changes in retained earnings, and of cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements referred to above present only the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary fund types.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California as of June 30, 1997 and 1996, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Deloitte & Touche LLP

September 12, 1997



Deloitte Touche
Tohmatsu
International

VETERANS FARM AND HOME BUILDING FUND OF 1943,
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

BALANCE SHEETS
JUNE 30, 1997 AND 1996 (in thousands)

| ASSETS | 1997 | 1996 |
|---|---|---|
| Cash in State Treasury | $ 12,773 | $ 14,114 |
| Investments: | | |
| Unrestricted | 675,517 | 642,474 |
| Restricted | 327,190 | 470,196 |
| Insurance administrators | 49,120 | 58,693 |
| | 1,051,827 | 1,171,363 |
| Total cash and investments | 1,064,600 | 1,185,477 |
| Receivables under contracts of sale, net of allowance for uncollectible contracts of $26,412 and $15,801 in 1997 and 1996, respectively | 2,127,730 | 2,216,193 |
| Due from Veterans Debenture Revenue Fund | 86,279 | 137,141 |
| Interest receivable: | | |
| State of California's Surplus Money Investment Fund | 477 | 2,986 |
| Investments | 17,766 | 21,995 |
| Due from other funds | 4,353 | 1,210 |
| Other real estate owned | 51,035 | 57,155 |
| Land, improvements and equipment, net of accumulated depreciation of $5,244 and $6,996 in 1997 and 1996, respectively | 7,834 | 8,437 |
| Other | 976 | 1,120 |
| TOTAL ASSETS | $3,361,050 | $3,631,714 |
| **LIABILITIES AND RETAINED EARNINGS** | | |
| LIABILITIES: | | |
| Accrued interest and other liabilities | $ 80,502 | $ 86,716 |
| Bonds payable - net | 2,953,312 | 3,181,518 |
| Insurance claims payable and loss reserves | 69,083 | 82,840 |
| Total liabilities | 3,102,897 | 3,351,074 |
| RETAINED EARNINGS | 258,153 | 280,640 |
| TOTAL LIABILITIES AND RETAINED EARNINGS | $3,361,050 | $3,631,714 |

See notes to financial statements.

VETERANS FARM AND HOME BUILDING FUND OF 1943,
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS
YEARS ENDED JUNE 30, 1997 AND 1996 (in thousands)

| | 1997 | 1996 |
|---|---|---|
| PROGRAM OPERATIONS: | | |
| Interest revenues: | | |
| Contracts of sale of properties | $ 175,186 | $ 182,636 |
| Investments and other | 71,105 | 84,325 |
| Transfers of interest revenue from Veterans Debenture Revenue Fund | 10,843 | 11,144 |
| Total program operations revenues | 257,134 | 278,105 |
| Expenses: | | |
| Interest expense | 230,871 | 245,971 |
| Provision for contract losses | 22,677 | 5,515 |
| Total program operations expenses | 253,548 | 251,486 |
| Excess of program operations revenues and transfers over interest expense and provision for contract losses | 3,586 | 26,619 |
| PROGRAM ADMINISTRATION: | | |
| Revenues: | | |
| Loan servicing fees | 1,385 | 1,426 |
| Other income | 905 | 343 |
| Excess of amounts charged to contract holders over fire and hazard insurance claims and expenses and changes in insurance reserves | 326 | |
| Total program administration revenues | 2,616 | 1,769 |
| Expenses: | | |
| Payroll and related costs | 11,342 | 10,885 |
| General expenses | 8,876 | 7,925 |
| Excess of fire and hazard insurance claims and expenses and changes in insurance reserves over amounts charged to contract holders | | 538 |
| Excess of self-insured life and disability insurance claims and expenses and changes in insurance reserves over amounts charged to contract holders | 162 | 10,239 |
| Total program administration expenses | 20,380 | 29,587 |
| Excess of program administration expenses over program administration revenues | (17,764) | (27,818) |
| LOSS ON SALE OF REPOSSESSED PROPERTY | (8,309) | (5,510) |
| DEFICIENCY OF REVENUES AND TRANSFERS OVER EXPENSES | (22,487) | (6,709) |
| RETAINED EARNINGS: | | |
| Beginning of year | 280,640 | 287,349 |
| End of year | $ 258,153 | $ 280,640 |

See notes to financial statements.

VETERANS FARM AND HOME BUILDING FUND OF 1943,
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 1997 AND 1996 (in thousands)

| | 1997 | 1996 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Deficiency of revenues and transfers in over expenses | $ (22,487) | $ (6,709) |
| Adjustments to reconcile to net cash used by operating activities: | | |
| Amortization of bond premiums, discounts and issuance costs | (46) | (36) |
| Depreciation expense | 716 | 849 |
| Loss on sale of repossessed property | 8,309 | 5,510 |
| Effect of changes in assets and liabilities: | | |
| Interest receivable - State of California's Surplus Money Investment Fund | 2,509 | 692 |
| Interest receivable - investments | (5,162) | (911) |
| Due from other funds | 4,229 | (185) |
| Other real estate owned | (2,189) | (21,742) |
| Other assets | 144 | 75 |
| Accrued interest and other liabilities | (6,214) | (4,152) |
| Insurance claims payable and loss reserves | (13,757) | (3,752) |
| Net cash used by operating activities | (33,948) | (30,361) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Net decrease in receivables under contracts of sale | 90,778 | 125,559 |
| Net decrease in investment securities | 117,221 | 163,866 |
| Purchase of land, improvements and equipment | (113) | (112) |
| Net cash provided by investing activities | 207,886 | 289,313 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net change in Due from Veterans Debenture Revenue Fund | 52,881 | 25 |
| Early redemption of bonds payable | (30,000) | (44,100) |
| Maturities on bonds payable | (198,160) | (205,355) |
| Net cash used by financing activities | (175,279) | (249,430) |
| INCREASE (DECREASE) IN CASH IN STATE TREASURY | (1,341) | 9,522 |
| CASH IN STATE TREASURY: | | |
| Beginning of year | 14,114 | 4,592 |
| End of year | $ 12,773 | $ 14,114 |

See notes to financial statements.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Description - The California Department of Veterans Affairs (the Department) is a separate legal entity and a Cabinet level agency of the State of California. A seven-member California Veterans Board (the Board) has policy oversight of the operations of the Department. The Board's membership consists of the Department Secretary and six members, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Veterans Farm and Home Building Fund of 1943 (the Fund) was established under the authority of the California Constitution to provide low-interest, long-term farm and home mortgage loan contracts to veterans living in California. The contract loan program has been continuous since 1922. Proceeds from the sale of general obligation bonds, periodically authorized by the vote of the people of California, and revenue bonds authorized by the Legislature are used for contract loans to veterans. Expenditures are primarily for debt service and administration of the program. The Fund is tax exempt.

The financial statements represent only the activities of the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary fund types. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

Use of Estimates in the Preparation of Financial Statements - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Accounting - The Fund has been classified as a governmental proprietary fund type for accounting purposes. Generally, revenues are recorded when earned and expenses are recognized as incurred.

Cash and Investments - Uncommitted bond proceeds restricted for loans to veterans are reflected in the balance sheet as restricted cash and investments. Investments in U.S. Treasury notes and bonds are carried at par, net of unamortized discounts and premiums. The discounts and premiums are amortized through the maturity dates of the underlying securities. The investments in the State of California's Surplus Money Investment Fund and investment agreements are carried at cost which approximates market value.

Receivables Under Contracts of Sale - Receivables under contracts of sale consist of the remaining contract principal balance plus unpaid interest accrued to date, net of the reserve for uncollectible accounts. The contract balance may also include amounts paid by the Fund for property taxes and insurance pending reimbursement from the contract holder.

Reserve for Uncollectible Accounts - The reserve for uncollectible accounts is established through a provision charged to operations. The reserve is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectibility and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation.

Other Real Estate Owned - Real estate acquired by repossession is carried at the lower of the contract balance or its net realizable value. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses.

Insurance Claims Payable and Loss Reserves - Insurance claims payable and loss reserves include unpaid claims, incurred but not reported (INBR) claims and loss reserves for the Fire and Hazard Insurance Plan and the benefits payable under the Department's remaining self-insured life and disability protection plan.

Fire and Hazard Insurance - This insurance program is provided to eligible contract holders as part of the loan program. The difference between premiums charged to contract holders and claims and expenses incurred and the change in loss reserves is included as a net amount in the statement of revenues, expenses and changes in retained earnings.

Self-Insured Life and Disability Protection Plan - From January 1, 1984 to June 1, 1996, the Department operated a self-funded protection plan whereby life and disability insurance was provided to eligible contract holders. The Department's self-insured life and disability protection plan was terminated effective June 1, 1996. The life and disability benefits previously available to these members under the self-insured protection plan continue to be available to those contract holders who were receiving benefits at the time the plan was terminated. Loss reserves to satisfy these obligations of the protection plan which include future disability and life benefits were actuarially determined using a long-term discount rate of 7%. Significant actuarial assumptions and methodologies used to calculate the reserve are interest, mortality, disability and prepayment.

Amortization of Bond Premiums, Discounts and Issuance Costs - Premiums and discounts arising from the issuance of bonds are amortized on a method which approximates the effective interest method. Expenses incurred in connection with the issuance of bonds are capitalized and amortized using the straight-line method.

Retirement Plan - The Department adopted Statement No. 27 of the Governmental Accounting Standards Board, *Accounting for Pensions by State and Local Government Employers*, effective for the fiscal year ended June 30, 1997.

Reclassifications - Certain 1996 amounts have been reclassified to conform with the 1997 presentation.

## 2. CASH AND INVESTMENTS

Cash in the State Treasury of $12,772,900 and $14,114,000 as of June 30, 1997 and 1996, respectively, represents amounts held in the Fund's general operating accounts with the State Treasury. These monies are pooled with the monies of other State agencies and invested by the State Treasurer's office. These assets are not individually identifiable.

Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California's Surplus Money Investment Fund, and investment agreements with financial institutions rated within the top two ratings of a nationally recognized rating service. The investments with the insurance administrator, held as a deposit in accordance with a master agreement for the remaining active life and disability insurance program for disabled contract holders, is authorized by California law.

The Fund's investment in investment agreements of $365,542,000 is carried at cost, which is equal to the value at expiration and approximates fair value. The interest rates on investment agreements are fixed at 6.64%, 7.66% and 7.66%, and expire on March 30, 1998, January 30, 1998, and July 30, 2019, respectively.

All of the Fund's investments in U.S. Treasury notes and bonds and the amounts administered by the insurance company are categorized as risk category 1, which is defined by the Governmental Accounting Standards Board (GASB) Statement No. 3 as investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. In accordance with GASB Statement No. 3, the Fund's investments held in the State of California's Surplus Money Investment Fund, the investment agreements and the mutual fund are not categorized because they are not evidenced by securities that exist in physical or book entry form.

The Fund's investments at June 30, 1997 and 1996 are as follows (in thousands):

| | 1997 | | 1996 | |
|---|---|---|---|---|
| | Carrying Amount | Approximate Market Value | Carrying Amount | Approximate Market Value |
| **Category 1:** | | | | |
| U.S. Treasury notes and bonds | $ 332,760 | $ 347,214 | $ 355,900 | $ 363,426 |
| Amounts held in trust fund with insurance administrators: | | | | |
| U.S. Treasury notes | 16,002 | 16,729 | 23,943 | 23,379 |
| Corporate bonds | 21,694 | 21,096 | 25,065 | 25,622 |
| Other | 7,688 | 7,689 | 6,427 | 6,409 |
| **Investments Not Subject to Categorization:** | | | | |
| State of California's Surplus Money Investment Fund | 304,405 | 304,405 | 281,026 | 281,027 |
| Investment agreements | 365,542 | 365,542 | 475,744 | 475,744 |
| Amounts held in trust fund with insurance administrators: | | | | |
| Mutual fund | 3,736 | 5,098 | 3,258 | 3,876 |
| | $1,051,827 | $1,067,773 | $1,171,363 | $1,179,483 |

## 3. RECEIVABLES UNDER CONTRACTS OF SALE

The Fund retains title to all real property subject to contracts of sale until the contract is satisfied. The veteran's contracts have original terms of 25-30 years and bear interest at rates of 4.4% to 9.0%, depending on the age and type of contract and the classification of the current contract holder.

## 4. BONDS PAYABLE

At June 30, 1997 and 1996, bonds payable included the following (in thousands):

| | 1997 | 1996 |
|---|---|---|
| General obligation bonds of the State of California, annual interest rates from 3.5% to 11.0% due in varying annual installments through 2027 (subject to varying redemption provisions) | $2,632,045 | $2,812,810 |
| Home purchase revenue bonds, annual interest rates from 6.1% to 8.3%, due in varying annual installments through 2019 (subject to varying redemption provisions) | 327,580 | 374,975 |
| | 2,959,625 | 3,187,785 |
| Discounts | (8,492) | (8,592) |
| Premiums | 2,179 | 2,325 |
| Total | $2,953,312 | $3,181,518 |

Future scheduled bond maturities at June 30, 1997 are as follows (in thousands):

| | |
|---|---|
| 1998 | $ 187,525 |
| 1999 | 193,360 |
| 2000 | 204,865 |
| 2001 | 207,940 |
| 2002 | 212,535 |
| Thereafter | 1,953,400 |
| | $2,959,625 |

General obligation bonds of the State of California are payable in accordance with the various veterans bond acts by the State General Fund. The full faith and credit of the State of California is pledged for the payment of both principal and interest. All general obligation bonds have an equal claim against the General Fund of the State of California. These bonds are included as obligations of the Fund when the proceeds from bond sales are received. The repayment for the bonds is the responsibility of the Fund. Authorized and unissued bonds under the Veterans Bond Acts of 1990 and 1996 are $654,370,000 at June 30, 1997.

Revenue bonds are special obligations of the Department payable solely from, and by a pledge of, an undivided interest in the assets of the Veterans Farm and Home Building Fund of 1943 and the Veterans Debenture Revenue Fund, a separate fund of the Department. The undivided interest in the net revenues of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of general obligation veterans bonds. At any point in time, authorized and unissued revenue bonds equal the $1.5 billion ceiling authorized in 1987 less revenue bonds outstanding at that time. At June 30, 1997 and 1996, authorized and unissued revenue bonds were $1,172,420,000 and $1,125,025,000, respectively.

The revenue bond resolutions require that an amount equal to 10% of the aggregate of the initial principal amount of all series of revenue bonds outstanding (the "Bond Reserve Requirement") be established in the Veterans Debenture Revenue Fund (a separate entity). If a revenue bond series is retired or matures in its entirety, the bond reserve requirement decreases. The investment earnings of the Veterans Debenture Revenue Fund are transferred to the Fund each year as provided by the revenue bond resolutions. Amounts in the Veterans Debenture Revenue Fund are restricted to paying the principal, interest and mandatory sinking fund payments on the revenue bonds or for retiring all revenue bonds then outstanding. At June 30, 1997 and 1996, the total assets of the Veterans Debenture Revenue Fund are shown as a receivable of the Fund. Complete financial statements of the Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California can be obtained by contacting the California Department of Veterans Affairs.

## 5. FIRE AND HAZARD INSURANCE

Fire and hazard insurance coverage is provided on behalf of contract holders for substantially all properties subject to contracts of sale. The program is funded by amounts charged to contract holders which are considered appropriate to cover losses incurred, premiums paid for excess insurance coverage and administration fees. From the amounts charged to contract holders, the Department pays losses up to $1,500,000 per occurrence or $13,000,000 per policy year. Coverage in excess of the above amounts is provided under a master policy with an insurance carrier which also administers the program. The loss reserve is based on the third party administrators estimate of incurred but not reported claims based on the historical trends and loss experience within the portfolio.

The excess (deficiency) of premiums charged to contract holders over (under) claims, expenses and change in loss reserves for the year ended June 30, 1997 and 1996 was as follows (in thousands):

| | 1997 | 1996 |
|---|---|---|
| Amounts charged to contract holders | $ 10,344 | $ 11,144 |
| (Less) plus: | | |
| Decrease in estimated loss reserve | 1,339 | 2,269 |
| Claims loss expense | (9,907) | (12,134) |
| Master policy premium | (622) | (619) |
| Administrative fees | (828) | (1,198) |
| Excess (deficiency) of amounts charged to contract holders over (under) claims and expenses and changes in reserves | $ 326 | $ (538) |

## 6. SELF-INSURED LIFE AND DISABILITY PROTECTION PLAN

The Department's self-insured life and disability protection plan was replaced on June 1, 1996, by a life and disability insurance plan provided by Pacific Mutual Group (PMG). Under the plan all Cal-Vet loan holders previously in the self-insured program were provided an opportunity to contract for the PMG plan regardless of age or health status. All new contract holders after the effective date are required to apply for this insurance.

At the time the Department's self-insured protection plan ended, approximately 1,727 contract holders were receiving disability benefits in the amount of their monthly loan payment at the time of their disability. As of June 30, 1997, approximately 1,500 contract holders were receiving disability and life benefits under the self-insured life and disability protection plan. These benefits will continue under the provisions of the self-insured plan until the beneficiary returns to active employment, dies, or their contract is paid off.

Loss reserves for these obligations have been actuarially determined. A portion of the required loss reserves are maintained under a third party administrator (TPA) agreement and are shown in the financial statements as investments with insurance administrators. During the year, the TPA reserves have been used to satisfy benefits payable under the self-insured protection plan. Earnings on investments held by the TPA were $3,732,472 and $4,815,000 in 1997 and 1996, respectively, and are included in interest revenues - investments and other in the financial statements.

The excess of claims expenses, changes in loss reserves, and administrative expenses over plan revenues whose coverages continue as obligations of the self-funded life and disability protection plan for the years ended June 30, 1997 and 1996 was as follows (in thousands):

| | 1997 | 1996 |
|---|---|---|
| Claims expenses: | | |
| Life insurance program | $ (1,564) | $ (9,858) |
| Disability insurance program | (10,843) | (10,513) |
| Total claims expenses | (12,407) | (20,371) |
| Decrease in estimated loss reserves | 12,418 | 1,483 |
| Net claims expenses and change in loss reserves | 11 | (18,888) |
| Plus plan revenues: | | |
| Life insurance program | 205 | 4,726 |
| Disability insurance program | 224 | 5,289 |
| Total | 429 | 10,015 |
| Less administrative fees | (602) | (1,366) |
| Excess of net claims expenses, change in loss reserves and administrative fees over plan revenues | $ (162) | $(10,239) |

## 7. COMMITMENTS AND CONTINGENCIES

As of June 30, 1997 and 1996, the Fund had loan commitments to veterans for the purchase of properties under contracts of sale of approximately $2,307,000 and $11,828,000, respectively.

The Department is a defendant in certain litigation related to the self-insured Life and Disability Protection Plan, formerly operated by the Department, and other matters. The Department, based on the advice of its counsel, believes that the suits are without merit and intends to vigorously defend its position. Management is of the opinion that the potential liability will not have a material adverse effect on the financial statements.

The Fund leases several buildings used as district offices. Rent expense for the years ended June 30, 1997 and 1996 was $482,057 and $502,280, respectively. Lease terms generally range from five to ten years with options to renew for additional periods. As of June 30, 1997, minimum annual rentals under operating leases are as follows (in thousands):

| | |
|---|---|
| 1998 | $ 391,992 |
| 1999 | 325,678 |
| 2000 | 265,380 |
| 2001 | 265,380 |
| 2002 | 219,828 |
| Thereafter | 112,874 |
| | $1,581,132 |

## 8. RETIREMENT PLAN

The Department, through the State of California, contributes to the California Public Employees Retirement System (CalPERS), which includes an agent multiple-employer public employee retirement system and a cost sharing multiple-employee plan that acts as a common investment and administrative agent for participating entities within the State of California. Substantially all full-time employees of the Fund are members of CalPERS. The Plan provides a monthly allowance based on age, years of credited service, and highest average compensation over an established period of time of one to three years. Vesting occurs after five to ten years. The Plan also provides death and disability benefits. The benefits are established by contract with CalPERS in accordance with the provisions of the Public Employees Retirement Law. CalPERS issues a publicly available Comprehensive Annual Financial Report that includes financial statements and required supplementary information for CalPERS. A copy of that report may be obtained by writing to CalPERS, Central Supply, P.O. Box 942715, Sacramento, CA 94229-2715.

Contributions to the Plan are funded by both the Department and the employee, and are actuarially determined by CalPERS based on covered compensation. State employees, with the exception of employees in the second-tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on a percentage of salary over a monthly base compensation amount of $238 to $863. With the exception of employees in the second-tier plan, state employees' required contributions vary from 5% to 8% of their salary over their base compensation amount.

For the fiscal years ended June 30, 1996 and June 30, 1997, the required State contribution rates ranged from 9.35% to 13.11%. Contributions by the Department to the Plan for the years ended June 30, 1997 and 1996 were approximately $1,042,000 and $987,000, or approximately 9.2% and 9.0% of participants salaries, respectively. Employee contributions to the Plan for the years ended June 30, 1997 and 1996 were approximately $305,000 and $315,000 or approximately 2.7% and 2.9% of participants salaries, respectively.

For fiscal years ended June 30, 1997 and 1996, the Department's annual pension cost was equal to the Department's required and actual contributions. The required contribution was determined as part of the June 30, 1995 actuarial valuation using the entry age normal actuarial cost method. The actuarial assumptions included (a) 8.5% investment rate of return, and (b) projected salary increases that vary by duration of service. Both (a) and (b) included an inflation component of 4.5%. The actuarial value of the Department's assets was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a five-year period. The underfunded actuarial accrued liability is being amortized as a level percentage of projected payroll on a closed basis. The remaining amortization period at June 30, 1995 was 34 years.

**Three-Year Fund Trend Information**

| Fiscal Year-End | Annual Pension Cost (APC) | Percentage of APC Contributed | Net Pension Obligation |
|---|---|---|---|
| June 30, 1995 | $814,000 | 100% | $0 |
| June 30, 1996 | $987,000 | 100% | $0 |
| June 30, 1997 | $1,042,000 | 100% | $0 |

**REQUIRED SUPPLEMENTARY INFORMATION**

Schedule of Funding Progress
For the Past Three Years for the
CalPERS State PERS Plans *
(In millions)

| Actuarial Valuation Date | Actuarial Value of Assets (a) | Actuarial Accrued Liability (AAL)- Entry Age (b) | Underfunded AAL (UAAL) (b-a) | Funded Ratio (a/b) | Estimated Covered Payroll (c) | UAAL as a Percentage of Covered Payroll ((b-a)/c) |
|---|---|---|---|---|---|---|
| June 30, 1994 | $32,294 | $36,055 | $3,761 | 89.6% | $8,070 | 46.6% |
| June 30, 1995 | $34,689 | $39,219 | $4,530 | 88.5% | $8,659 | 52.3% |
| June 30, 1996 | $38,917 | $41,867 | $2,950 | 93.0% | $8,924 | 33.1% |

*Department and Fund information is not separately available.

## 9. SUBSEQUENT EVENTS

During August 1997, the Fund called approximately $1,810,000 of revenue bonds and approximately $4,950,000 of general obligation bonds pursuant to the terms and early call provisions of the bond agreements.

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# CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA

## Contracts of Purchase

Set forth below is certain financial information regarding Contracts of Purchase.

### *Existing Contracts of Purchase*

The following charts describe the current loan to value ratios and geographic distribution of Contracts of Purchase financed under the Program as of December 31, 1997, using proceeds of Veterans G.O. Bonds and Revenue Bonds.

**Current Loan-to-Value Ratio of Contracts of Purchase(1)**

| | Current Contracts of Purchase Balance (000s) |
|---|---|
| **Single Family Homes** | |
| Less than 30% LTV | $ 127,823 |
| 30-49% LTV | 295,174 |
| 50-59% LTV | 204,017 |
| 60-69% LTV | 252,586 |
| 70-79% LTV | 294,463 |
| Sub-total | $1,174,064 |
| 80-84% LTV | $ 135,445 |
| 85-89% LTV | 266,292 |
| 90-94% LTV | 410,644 |
| 95-97% LTV | 15,665 |
| Sub-total | $ 828,046 |
| Other High LTV Contracts(2) | $ 24,943 |
| Total | $2,027,053 |
| **Other Property Types** | |
| Farms | $ 6,046 |
| Mobile Homes in Parks | 11,761 |
| Total | $ 17,807 |
| **Special Status Contracts of Purchase** | |
| Real Estate Owned(3) | $ 64,722 |
| Disability Program(4) | 58,411 |
| Total | $ 123,132 |
| Total Portfolio | $2,167,992 |

(1) LTV based on current Contracts of Purchase balance (net of accrued interest, advanced taxes and insurance) divided by original appraised value of property.

(2) Consists of Contracts of Purchase where delinquent accrued interest and charges have been added to Contracts of Purchase balance.

(3) Repossessed properties and delinquent Contracts of Purchase carried as REO on financial statements.

(4) Contracts of Purchase where payments are made on behalf of veteran by the Department's life and disability coverage plan.

## Geographic Distribution of Contracts of Purchase

| County | Approximate Current Contract Balance (000s) |
|---|---|
| Sacramento | $ 238,545 |
| Los Angeles | 172,466 |
| San Bernardino | 164,506 |
| Fresno | 124,057 |
| San Diego | 117,786 |
| Kern | 115,742 |
| Riverside | 102,692 |
| Orange | 94,096 |
| San Joaquin | 65,857 |
| Placer | 60,761 |
| Solano | 56,377 |
| Shasta | 53,831 |
| Contra Costa | 50,879 |
| Other Northern California Counties | 426,685 |
| Other Central California Counties | 264,811 |
| Other Southern California Counties | 58,902 |
| Statewide—California | $2,167,992* |

*Amounts may not total due to rounding.

### *Contracts of Purchase Origination and Principal Repayment Experience*

The following tables present, respectively, a historical picture of Contract of Purchase originations since the 1984-85 fiscal year and selected principal repayments with respect to Contracts of Purchase since the 1977-1978 fiscal year.

## New Contracts of Purchase During the Fiscal Year(1)

| Fiscal Year Ending June 30 | Veterans G.O. Bonds | | Revenue Bonds | | Total | |
|---|---|---|---|---|---|---|
| | Number | Amount | Number | Amount | Number | Amount |
| 1985 | 4,196 | $290,885,900 | 2,301 | $154,244,600 | 6,497 | $445,130,500 |
| 1986 | 3,484 | 243,955,800 | 2,401 | 160,782,200 | 5,885 | 404,738,000 |
| 1987 | 1,569 | 108,789,700 | 1,160 | 75,836,800 | 2,729 | 184,626,500 |
| 1988 | 2,958 | 236,054,500 | 1,397 | 99,040,900 | 4,355 | 335,095,400 |
| 1989 | 3,112 | 252,796,300 | 1,154 | 83,076,100 | 4,266 | 335,872,400 |
| 1990 | 2,097 | 187,445,600 | 522 | 38,150,800 | 2,619 | 225,596,400 |
| 1991 | 1,927 | 200,393,500 | 359 | 29,189,600 | 2,286 | 229,583,100 |
| 1992 | 1,086 | 111,600,500 | 388 | 34,671,600 | 1,474 | 146,272,100 |
| 1993 | 740 | 94,417,100 | 286 | 27,443,800 | 1,026 | 121,860,900 |
| 1994 | 843 | 117,213,779 | 337 | 34,740,536 | 1,180 | 151,954,315 |
| 1995 | 2,109 | 286,178,376 | 822 | 84,860,894 | 2,931 | 371,039,270 |
| 1996 | 762 | 107,751,444 | 222 | 22,723,617 | 984 | 130,475,061 |
| 1997 | 766 | 118,344,636 | 201 | 21,853,933 | 967 | 140,198,569 |
| 1998(2) | 427 | 59,503,695 | 97 | 10,904,132 | 524 | 70,407,827 |

(1) Number of new Contracts of Purchase includes home improvement loans; dollar amounts exclude home improvement loans.

(2) 6-month period through December 31, 1997.

## Selected Principal Flows with respect to Contracts of Purchase

## Funded by both Veterans G.O. Bonds and Revenue Bonds

| Fiscal Year Ending June 30 | Contracts Funded During Year ($000's) | Contract Prepayments During Year ($000's) | Other Principal Receipts—Losses During Year ($000's) | Contract Balance at End of Year ($000's) | Average Base Contract Rate | Average of Monthly FHMLC 30-year Conventional Loan Rate | Annual Average Prepayment Rate | Annual Average Origination Rate |
|---|---|---|---|---|---|---|---|---|
| | Principal Flows | | | | Rates | | | |
| 1978 | — | — | — | 1,538,524 | — % | — % | — % | — % |
| 1979 | 340,227 | 124,864 | 68,240 | 1,685,647 | 5.6 | — | 7.7 | 21.1 |
| 1980 | 716,662 | 100,540 | 69,079 | 2,232,690 | 5.6 | — | 5.1 | 36.6 |
| 1981 | 417,628 | 82,393 | 70,472 | 2,497,453 | 6.6 | 14.0 | 3.5 | 17.7 |
| 1982 | 279,239 | 44,608 | 74,891 | 2,657,193 | 7.3 | 17.3 | 1.7 | 10.8 |
| 1983 | 254,086 | 92,146 | 87,536 | 2,731,597 | 8.0 | 14.6 | 3.4 | 9.4 |
| 1984 | 405,616 | 132,911 | 94,930 | 2,909,372 | 8.0 | 13.4 | 4.7 | 14.4 |
| 1985 | 445,131 | 123,669 | 88,308 | 3,142,526 | 8.0 | 13.8 | 4.1 | 14.7 |
| 1986 | 404,738 | 179,809 | 94,970 | 3,272,485 | 8.0 | 11.5 | 5.6 | 12.6 |
| 1987 | 184,627 | 261,675 | 99,569 | 3,095,868 | 7.7 | 9.8 | 8.2 | 5.8 |
| 1988 | 335,095 | 198,396 | 114,178 | 3,118,389 | 7.0 | 10.5 | 6.4 | 10.8 |
| 1989 | 335,872 | 207,471 | 105,896 | 3,140,894 | 7.3 | 10.6 | 6.6 | 10.7 |
| 1990 | 225,596 | 232,085 | 96,639 | 3,037,766 | 8.0 | 10.1 | 7.5 | 7.3 |
| 1991 | 229,583 | 191,895 | 92,722 | 2,982,732 | 8.0 | 9.9 | 6.4 | 7.6 |
| 1992 | 146,272 | 246,150 | 92,975 | 2,789,879 | 8.0 | 9.0 | 8.5 | 5.1 |
| 1993 | 121,861 | 273,817 | 105,629 | 2,532,294 | 8.0 | 8.0 | 10.3 | 4.6 |
| 1994 | 151,954 | 359,749 | 98,773 | 2,225,726 | 8.0 | 7.3 | 15.1 | 6.4 |
| 1995 | 371,039 | 111,984 | 74,706 | 2,410,075 | 7.8 | 8.7 | 4.8 | 16.0 |
| 1996 | 130,475 | 141,767 | 92,521 | 2,306,262 | 8.0 | 7.5 | 6.0 | 5.5 |
| 1997 | 140,199 | 111,254 | 106,027 | 2,229,180 | 8.0 | 7.9 | 4.9 | 6.2 |
| 1998[(1)] | 70,408 | 81,374 | 50,234 | 2,167,853 | 8.0 | 7.3 | 7.4 | 6.4 |
| | 5,706,308 | 3,298,557 | 1,778,295 | | | | | |

[(1)] 6-month period through December 31, 1997.

### *Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments*

The following amounts following the issuance of the Offered Veterans G.O. Bonds are expected to become available to fund Contracts of Purchase. The universe of veterans eligible to receive Contracts of Purchase financed by the different classifications of available moneys are described under "THE PROGRAM—Qualifying Veteran Status." Additional moneys may become available to finance Contracts of Purchase through the future issuances of Veterans G.O. Bonds and Revenue Bonds. The Department has full discretion to use moneys available from prior, current or future bond issues in any order of priority it chooses.

| | | Respective Series Bond Proceeds Subaccounts | | | | |
|---|---|---|---|---|---|---|
| Bond Series | Issuance Date or Expected Issuance Date | Unrestricted Moneys[1] | Qualified Veterans Mortgage Bond Proceeds[1] | Qualified Mortgage Bond Proceeds[1] | Investment Agreement | Investment Rate(%) |
| Veterans G.O. Bonds | | | | | | |
| Series BC, BD, BE, BF | 3/30/95 | -0- | 20,000 | -0- | Soc Gen [2,3] | 6.635 |
| Series BG, BH, BK, BL | 12/29/97 and 1/5/98 | -0- | 165,000 | -0- | Soc Gen [2,4] | 5.71 |
| Series BJ[10] | 12/29/97 | -0- | 300,000 | -0- | Soc Gen [2,5] | 5.52 |
| Series BM, BN[11] | 3/26/98 | 20,000 | -0- | -0- | FCMSI [6] | 5.62 |
| Series BP[11] | 5/5/98 | | 14,000 | -0- | Trinity [7] | 5.702 |
| 1984 Code G.O. Bond Series Recycling Subaccount | N.A. | -0- | 35,000 | -0- | Soc Gen [2,4] | 5.71 |
| Unrestricted G.O. Bond Series Recycling Subaccount | N.A. | 80,000 | -0- | -0- | Trinity [7] | 5.702 |
| Total with respect to Veterans G.O. Bonds | | 100,000 | 534,000 | -0- | | |
| Revenue Bonds | | | | | | |
| 1997 Series C[10] | 12/29/97 | -0- | -0- | 93,000 | Soc Gen [2,8] | 5.57 |
| 143 Revenue Bond Series Recycling Subaccount | N.A. | -0- | -0- | 231,000 | Soc Gen [2,9] | 5.73 |
| Total with respect to Revenue Bonds | | -0- | -0- | 324,000 | | |
| Total | | $100,000 | $534,000 | $324,000 | | |

(1) 000s omitted.

(2) On January 16, 1998, Moody's announced that it had placed under review for possible downgrade Societe Generale's long-term ratings (senior debts and deposits, currently rated at A3 by Moody's) and its bank financial strength rating (currently rated at B by Moody's). Moody's said that the ratings actions on Societe General "were prompted by concerns over the bank's exposure in Asia and the impact that recent and ongoing credit events in the region might have on the financial strength and profitability of the bank."

(3) Investment agreement maturing March 30, 1998 with Societe Generale.

(4) Investment agreement maturing December 1, 2000 with Societe Generale.

(5) Investment agreement maturing December 1, 1999 with Societe Generale.

(6) Investment agreement maturing April 1, 2000 with FGIC Capital Market Services, Inc. ("FCMSI"). The payment obligations of FCMSI under the investment agreement will be guaranteed by General Electric Capital Corporation ("GE Capital").

(7) Investment agreement maturing April 1, 2001 with Trinity Plus Funding Company, LLC ("Trinity"). Under certain circumstances, Trinity will have the benefits of a letter of credit from GE Capital and of a revolving liquidity facility under which GE Capital is a lender (there can be additional lenders under the liquidity facility). However, the aggregate of the amounts available under the letter of credit and the liquidity facility may be significantly less than Trinity's obligations under its investment agreements.

(8) Investment agreement maturing December 1, 1999 with Societe Generale.

(9) Investment agreement maturing December 1, 2001 with Societe Generale.

(10) Proceeds will become available only with respect to those bonds on which the interest rate has been adjusted to fixed interest rates to maturity.

(11) The Offered Veterans G.O. Bonds.

As of December 31, 1997, the Department had 105 pending applications in the aggregate amount of approximately $9,850,000.

### Cancellations and Delinquencies

Set forth in the table below is a five-year comparative chart of delinquent, cancelled and repossessed Contracts of Purchase and certain comparative information regarding USDVA guaranteed loans during the same period.

| | 1993[1] | 1994[1] | 1995[1] | 1996[1] | 1997[2] |
|---|---|---|---|---|---|
| **Percentage of Number of Contracts of Purchase** | | | | | |
| Delinquent[3] | | | | | |
| 30-67 days | 1.25% | 1.19% | 1.28% | 1.86% | 0.80% |
| 68+ days | 3.39% | 4.50% | 1.90% | 3.32% | 2.58% |
| Cancelled Contracts and Bankruptcies[4] | 0.28% | 0.35% | 0.70% | 0.70% | 0.93% |
| Repossessed Contracts | 0.34% | 0.42% | 0.88% | 1.16% | 0.55% |
| **USDVA Guaranteed Loans[5]** | | | | | |
| Percentages in U.S. | | | | | |
| Delinquent | | | | | |
| 30-60 days | 4.19% | 4.07% | 4.14% | 4.59% | 4.67% |
| 60+ days | 2.18% | 2.25% | 2.21% | 2.20% | 2.41% |
| Foreclosures in inventory | 1.35% | 1.44% | 1.26% | 1.54% | 1.87% |
| Percentages in California | | | | | |
| Delinquent | | | | | |
| 30-60 days | 3.80% | 3.42% | 4.03% | 4.23% | 4.69% |
| 60+ days | 2.56% | 2.36% | 2.53% | 2.36% | 2.81% |
| Foreclosures in inventory | 1.93% | 2.28% | 2.31% | 3.18% | 3.50% |

(1) As of December 18 for Department's data and June 30 for USDVA data.

(2) Department information is as of December 31, 1997. USDVA information currently is not available and is shown as of September 30, 1997.

(3) Time periods conform to Department's record-keeping system.

(4) Bankruptcies are included in cancelled Contracts statistics and do not exceed in any period more than 10% of total cancellations and bankruptcy category. Federal bankruptcy law precludes repossession action of Contracts of Purchase when veteran is in bankruptcy proceedings until the automatic stay is lifted.

(5) Source: National Delinquency Survey published by the Mortgage Bankers Association of America.

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### Veterans G.O. Bonds and Revenue Bonds

The chart below sets forth certain information regarding Veterans G.O. Bonds and Revenue Bonds, including those expected to be redeemed, defeased or retired as a result of the issuance of the Offered Veterans G.O. Bonds.

## Selected Information with Respect to Outstanding Veterans G.O. Bonds and Revenue Bonds

| Series | Bonds Outstanding as of 2/2/1998 | Bonds Expected to be Outstanding as of 5/5/1998 | Final Maturity or Mandatory Tender Date of Series | Next Optional Call Date | Call Price on Such Date | Maximum Coupon Subject to Optional Call | Bond Subject to Special Redemption |
|---|---|---|---|---|---|---|---|
| **Veterans G.O. Bonds Issued Prior to the Mortgage Subsidy Bond Tax Act of 1980** | | | | | | | |
| PP | $ 4,800,000 | $ 4,800,000 | October 1, 1998 | Non-callable | N.A. | N.A. | No |
| QQ | 9,600,000 | 9,600,000 | February 1, 2000 | Non-callable | N.A. | N.A. | No |
| TT | 10,800,000 | — [1] | | | | | |
| UU | 19,200,000 | — [2] | | | | | |
| VV | 18,000,000 | — [2] | | | | | |
| WW | 42,600,000 | — [1] | | | | | |
| XX | 28,400,000 | — [2] | | | | | |
| YY | 49,200,000 | 42,600,000 | April 1, 2004 | April 1, 1999 | 100% | 5.900% | No |
| ZZ/AB | 41,000,000 | 35,500,000[2] | August 1, 2004 | August 1, 1999 | 100% | 5.750% | No |
| AC | 41,000,000 | 35,500,000[2] | August 1, 2004 | August 1, 1999 | 100% | 5.700% | No |
| AD | 55,800,000 | 49,200,000 | April 1, 2005 | April 1, 2000 | 100% | 6.800% | No |
| AE | 29,760,000 | 26,240,000[2] | August 1, 2005 | August 1, 2000 | 100% | 7.000% | No |
| AF | 44,640,000 | 39,360,000[2] | August 1, 2005 | August 1, 2000 | 100% | 7.300% | No |
| AG | 55,800,000 | 55,800,000 | October 1, 2005 | October 1, 2000 | 100% | 8.250% | No |
| Sub-total | $450,600,000 | $298,600,000 | | | | | |
| **Veterans G.O. Bonds Issued to Refund Bonds Issued Prior to the Mortgage Subsidy Bond Tax Act of 1980** | | | | | | | |
| BM | — [3] | $ 66,600,000 | December 1, 2025[3] | — [3] | — [3] | 5.45%[3] | Excess Revenues/ Unexpended[3] |
| BN2-4 | — [3] | $ 91,065,000 | December 1, 2028[3] | — [3] | — [3] | 5.45%[3] | Excess Revenues/ Unexpended[3] |
| | | 157,665,000 | | | | | |
| **Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1954 Code** | | | | | | | |
| AH | $ 60,000,000 | $ 56,000,000[2] | August 1, 2006 | August 1, 2001 | 100% | 10.000% | No |
| AK | 13,500,000 | 13,500,000 | April 1, 2007 | Non-callable | N.A. | N.A. | No |
| AL | 44,000,000 | 44,000,000 | April 1, 2007 | Non-callable | N.A. | N.A. | No |

| Series | Bonds Outstanding as of 2/2/1998 | Bonds Expected to be Outstanding as of 5/5/1998 | Final Maturity or Mandatory Tender Date of Series | Next Optional Call Date | Call Price on Such Date | Maximum Coupon Subject to Optional Call | Bond Subject to Special Redemption |
|---|---|---|---|---|---|---|---|
| **Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1954 Code** | | | | | | | |
| AM | $ 65,000,000 | $ 65,000,000 | October 1, 2008 | Non-callable | N.A. | N.A. | No |
| AN/AP | 92,000,000 | 91,500,000 | April 1, 2009 | Non-callable | N.A. | N.A. | No |
| AQ | 97,500,000 | 97,500,000 | October 1, 2008 | Non-callable | N.A. | N.A. | No |
| AR | 47,500,000 | 47,500,000 | October 1, 2009 | Non-callable | N.A. | N.A. | No |
| AS | 49,000,000 | 49,000,000 | October 1, 2009 | Non-callable | N.A. | N.A. | No |
| AT | 207,485,000 | 207,485,000 | February 1, 2010 | Non-callable | N.A. | N.A. | No |
| AU | 138,930,000 | 138,930,000 | October 1, 2010 | Non-callable | N.A. | N.A. | No |
| AV | 95,170,000 | 95,170,000 | October 1, 2010 | Non-callable | N.A. | N.A. | No |
| Sub-total | $ 910,085,000 | $ 905,585,000 | | | | | |
| **Veterans G.O. Bonds Issued as Qualifed Veterans Mortgage Bonds under the 1986 Code** | | | | | | | |
| BC/BF[4] | 348,745,000 | 338,745,000[2] | February 1, 2027 | April 1, 1998 | 102% | 6.550% | Allocated Prepayments[5] |
| BG/BH | 586,355,000 | 586,355,000 | December 1, 2032 | —[6] | —[6] | 5.600%[6] | Excess Revenues/ Unexpended |
| BJ | 300,000,000 | 300,000,000 | June 1, 1999 | October 1, 1998 | 100% | 4.125% | No |
| BK/BL | 280,615,000 | 280,615,000 | December 1, 2012 | —[6] | —[6] | 5.300%[6] | Excess Revenues/ Unexpended |
| BP/BN1[3] | — | 14,000,000[3] | December 1, 2026[3] | —[3] | —[3] | 5.50%[3] | Excess Revenues/ Unexpended[3] |
| Sub-total | $1,515,715,000 | $1,519,715,000 | | | | | |
| TOTAL VETERANS G.O. BONDS | $2,876,400,000 | $2,881,565,000 | | | | | |
| **Revenue Bonds Issued as Qualified Mortgage Bonds under the 1986 Code** | | | | | | | |
| 1997 A/B | 20,990,000 | 20,990,000 | December 1, 2028 | December 1, 2008 | 101% | 5.500% | Excess Revenues/ Unexpended |
| 1997 C | 100,000,000 | 100,000,000 | December 1, 1999 | December 1, 1998 | 100% | 4.200% | No |
| 1998 A | — | 154,065,000 | December 1, 2019 | December 1, 2008 | 101% | 5.450% | Excess Revenues/ Unexpended |
| TOTAL REVENUE BONDS | $ 120,990,000 | $ 275,055,000 | | | | | |
| TOTAL ALL BONDS | $2,997,390,000 | $3,156,620,000 | | | | | |

[1] Reduction in amount reflects those Veteran G.O. Bonds expected to be retired from amounts in the 1943 Fund on or about April 1, 1998.

[2] Reduction in amount reflects those Veteran G.O. Bonds expected to be retired following expected sale and delivery of Offered Veterans G.O. Bonds on or about May 5, 1998.

[3] The Offered Veterans G.O. Bonds, Series BM Bonds and Series BN Bonds maturing on and before December 1, 2004 are subject to optional redemption at par on and after June 1, 2000. The remaining Series BM Bonds and Series BN Bonds and all of the Series BP Bonds are subject to optional redemption on and after December 1, 2003, initially at 101% of the principal amount thereof, declining to par on and after December 1, 2004.

[4] Includes Series BC, Series BD, Series BE and Series BF.

[5] Subject to redemption at par from portion of prepayments on all Contracts of Purchase as allocated to Series based on periodically determined ratio of outstanding bonds (including Veterans G.O. Bonds and Revenue Bonds) of Series to all outstanding bonds.

[6] Except as described in the next sentence, the Series BG Bonds, Series BH Bonds, and Series BL Bonds are subject to optional redemption on and after December 1, 2008, initially at 101% of the principal amount thereof, declining to par on December 1, 2009. The Series BH Bonds maturing on December 1, 2018, December 1, 2024, and December 1, 2032 are subject to optional redemption on and after December 1, 2003 at 102% of the principal amount thereof, declining to 101% of the principal amount thereof on and after December 1, 2004, and declining further to par on December 1, 2005. The Series BK Bonds are not subject to optional redemption.

### Additional Investments

In addition to the investments described above under "Contracts of Purchase—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments," the following investments have been made with respect to moneys in the 1943 Fund and the Bond Reserve Account which secures the Revenue Bonds:

| Fund or Account Designation[1] | Amount | Type of Investment | Investment Provider | Investment Maturity Date | Investment (%) |
|---|---|---|---|---|---|
| 1997/1998 Bond Reserve Subaccount | $5,251,650[2] | investment agreement | Societe Generale[3] | 12/1/28 | 5.75 |
| 1997/1998 Revenue Bond Series Revenue Subaccount and 1997/1998 Revenue Bond Series Restricted Recoveries Subaccount | variable | investment agreement | Societe Generale[3] | 12/1/28 | 5.91 |
| BG, BH, BK, BL G.O. Bond Series Revenue Subaccount and BG, BH, BK, BL G.O. Bonds Series Recycling Subaccount | variable | investment agreement[4] | Societe Generale[3] | 12/1/32 | 5.91 |
| BM, BN G.O. Bond Series Revenue Subaccount | variable | investment agreement | Westdeutsche Landesbank Girozentrale | 12/1/28 | 5.38 |
| BM, BN G.O. Bond Series Recycling Subaccount | variable[5] | investment agreement | Westdeutsche Landesbank Girozentrale | 12/1/28 | 5.38 |
| BP G.O. Bond Series Revenue Subaccount | variable | investment agreement | Westdeutsche Landesbank Girozentrale | 12/1/28 | 5.38 |
| BP G.O. Bond Series Recycling Subaccount | variable[5] | investment agreement | Westdeutsche Landesbank Girozentrale | 12/1/28 | 5.38 |

(1) Accounts are established in the resolutions authorizing the issuance of Revenue Bonds.

(2) $1,469,300 of this amount represents all of the amounts established with respect to the Home Purchase Revenue Bonds, 1997 Series A and 1997 Series B, and the balance represents the amount (which can be withdrawn if the expected issuance of the 1998 Series A Bonds does not occur) established with respect to the Home Purchase Revenue Bonds, 1998 Series A.

(3) On January 16, 1998, Moody's announced that it had placed under review for possible downgrade Societe Generale's long-term ratings (senior debts and deposits, currently rated at A3 by Moody's) and its bank financial strength rating (currently rated at B by Moody's). Moody's said that the ratings actions on Societe General "were prompted by concerns over the bank's exposure in Asia and the impact that recent and ongoing credit events in the region might have on the financial strength and profitability of the bank."

(4) Maximum permitted amount on deposit under investment agreement at any one time is $250,000,000.

(5) Aggregate maximum permitted amount on deposit under investment agreement for both accounts is $50,000,000.

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## APPENDIX C

## BOOK-ENTRY SYSTEM

The information in this section concerning DTC and DTC's book-entry only system has been obtained from sources that the Treasurer believes to be reliable, but the Treasurer takes no responsibility for the accuracy thereof. The Beneficial Owners (as defined herein) should confirm the following information with DTC or the DTC Participants.

DTC will act as securities depository for the Offered Veterans G.O. Bonds. The Offered Veterans G.O. Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC's partnership nominee). Fully-registered Offered Veterans G.O. Bonds will be issued and deposited with DTC.

DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds securities that its participants (the "DTC Participants") deposit with DTC. DTC also facilitates the settlement among DTC Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in DTC Participants' accounts, thereby eliminating the need for physical movement of securities certificates. Direct DTC Participants include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is owned by a number of its Direct DTC Participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as securities brokers and dealers, banks and trust companies that clear through or maintain a custodial relationship with a Direct DTC Participant, either directly or indirectly ("Indirect DTC Participants"). The Rules applicable to DTC and its DTC Participants are on file with the Securities and Exchange Commission.

Purchases of the Offered Veterans G.O. Bonds under the DTC system must be made by or through Direct DTC Participants, which will receive a credit for the Offered Veterans G.O. Bonds on DTC's records. The ownership interest of each actual purchaser of each Offered Veterans G.O. Bond (the "Beneficial Owner") is in turn to be recorded on the Direct and Indirect DTC Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect DTC Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Offered Veterans G.O. Bonds are to be accomplished by entries made on the books of DTC Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the Offered Veterans G.O. Bonds, except in the event that use of the book-entry system for the Offered Veterans G.O. Bonds is discontinued.

To facilitate subsequent transfers, all Offered Veterans G.O. Bonds deposited by DTC Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. The deposit of Offered Veterans G.O. Bonds with DTC and their registration in the name of Cede & Co. effect no change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Offered Veterans G.O. Bonds; DTC's records reflect only the identity of the Direct DTC Participants to whose accounts such securities are credited, which may or may not be the Beneficial Owners. The DTC Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct DTC Participants, by Direct DTC Participants to Indirect DTC Participants, and by Direct DTC Participants and Indirect DTC Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. The Treasurer will not have any responsibility or obligation to such DTC Participants or the persons for whom they act as nominees with respect to the Offered Veterans G.O. Bonds.

Redemption notices shall be sent to Cede & Co. If less than all of the Offered Veterans G.O. Bonds within a maturity of a Series are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct DTC Participant in such maturity to be redeemed.

The principal, premium and interest payment with respect to the Offered Veterans G.O. Bonds will be made to DTC. DTC's practice is to credit Direct DTC Participants' accounts on payment dates in accordance with their respective holdings shown on DTC's records unless DTC has reason to believe that it will not receive payment on the date payable. Payments by DTC Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such DTC Participant and not of DTC or the Treasurer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal and interest to DTC is the responsibility of the Treasurer, disbursement of such payments to Direct DTC Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect DTC Participants.

DTC may discontinue providing its services as securities depository with respect to the Offered Veterans G.O. Bonds at any time by giving reasonable notice to the Treasurer. Under such circumstances, in the event that a successor securities depository is not obtained, certificates are required to be printed and delivered.

The Treasurer may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, securities certificates will be printed and delivered.

SO LONG AS CEDE & CO. IS THE REGISTERED OWNER OF THE OFFERED VETERANS G.O. BONDS, AS NOMINEE OF DTC, REFERENCES HEREIN TO THE OWNERS OF OFFERED VETERANS G.O. BONDS SHALL MEAN CEDE & CO., AS AFORESAID, AND SHALL NOT MEAN THE BENEFICIAL OWNERS OF THE OFFERED VETERANS G.O. BONDS.

NEITHER THE STATE NOR THE TREASURER WILL HAVE ANY RESPONSIBILITY OR OBLIGATION TO DIRECT DTC PARTICIPANTS, INDIRECT PARTICIPANTS, OR TO ANY BENEFICIAL OWNER WITH RESPECT TO (i) THE ACCURACY OF ANY RECORDS MAINTAINED BY DTC, ANY DIRECT DTC PARTICIPANT, OR INDIRECT DTC PARTICIPANT; (ii) THE DELIVERY OF ANY NOTICE THAT IS PERMITTED OR REQUIRED TO BE GIVEN TO THE OWNERS OF THE OFFERED VETERANS G.O. BONDS; (iii) THE PAYMENT BY DTC OR ANY DIRECT DTC PARTICIPANT OR INDIRECT DTC PARTICIPANT OF ANY AMOUNT WITH RESPECT TO THE PRINCIPAL OR INTEREST DUE WITH RESPECT TO THE OFFERED VETERANS G.O. BONDS; (iv) ANY CONSENT GIVEN OR OTHER ACTION TAKEN BY DTC AS THE REGISTERED OWNER OF OFFERED VETERANS G.O. BONDS; OR (v) ANY OTHER MATTER.

## APPENDIX D

## SUMMARY OF CONTINUING DISCLOSURE CERTIFICATES

### *STATE TREASURER'S DISCLOSURE CERTIFICATE*

The State Treasurer, on behalf of the State will execute a Continuing Disclosure Certificate (the "Treasurer's Disclosure Certificate") for the Offered Veterans G.O. Bonds at the time of delivery of the Offered Veterans G.O. Bonds to the purchasers thereof. The following is a summary of the provisions of the Treasurer's Disclosure Certificate. Such summary is qualified by reference to the complete Treasurer's Disclosure Certificate, which is available from the Office of the State Treasurer.

**Definitions**

Pursuant to the Treasurer's Disclosure Certificate, the following definitions will apply:

"Annual Report" shall mean the Annual Report filed by the State Treasurer pursuant to, and as described in, the Treasurer's Disclosure Certificate.

"Beneficial Owner" shall mean any person which has or shares the power, directly or indirectly, to make investment decisions concerning ownership of any Offered Veterans G.O. Bonds (including persons holding Offered Veterans G.O. Bonds through nominees, depositories or other intermediaries).

"Dissemination Agent" shall mean the State Treasurer, acting in its capacity as Dissemination Agent under the Treasurer's Disclosure Certificate, or any successor Dissemination Agent designated in writing by the State Treasurer.

"Holder" shall mean any person listed on the registration books of the State Treasurer as the registered owner of any Offered Veterans G.O. Bonds.

"Listed Events" shall mean any of the events listed below under "Reporting of Significant Events."

"National Repository" shall mean any Nationally Recognized Municipal Securities Information Repository certified by the Securities and Exchange Commission to be the recipient of information of the nature of the Annual Reports required by the Disclosure Certificate.

"Official Statement" shall mean the official statement relating to the Offered Veterans G.O. Bonds, dated                    , 1998.

"Repository" shall mean each National Repository and the State Repository.

"Rule" shall mean Rule 15c2-12(b)(5) adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as the same may be amended from time to time.

"State" shall mean the State of California.

"State Repository" shall mean any public or private repository or entity within the State created for the purpose of receiving information of the nature of the Annual Reports or reports of material events required by the Treasurer's Disclosure Certificate and recognized as such by the Securities and Exchange Commission. As of the date of this Official Statement, there is no State Repository.

**Annual Reports**

The State Treasurer on behalf of the State shall, not later than April 1 of each year in which the Bonds are outstanding, commencing with the report for the 1997-98 Fiscal Year, provide an Annual Report consistent with the requirements of the Treasurer's Disclosure Certificate (an

"Annual Report") to each Repository; provided that the audited financial statements of the State may be submitted separately from the balance of the Annual Report and later than the date required above for the filing of the Annual Report if they are not available by that date. The State Treasurer shall make a copy of any Annual Report available to any person who requests a copy at a cost not exceeding the reasonable cost of duplication and delivery.

If in any year, the State Treasurer does not provide the Annual Report to each Repository by the time specified above, the State Treasurer shall instead file a notice with each Repository stating that the Annual Report has not been timely completed and, if known, stating the date by which the State Treasurer expects to file the Annual Report.

The Annual Report shall contain or include by reference the following:

(1) The audited General Purpose Financial Statements of the State for the fiscal year ended on the previous June 30, prepared in accordance with generally accepted accounting principles promulgated to apply to government entities from time to time by the Governmental Accounting Standards Board. If the State's audited financial statements are not available by the time the Annual Report is required to be filed pursuant to the Disclosure Certificate, the Annual Report shall contain unaudited financial statements in a format similar to the financial statements contained in the final Official Statement, and the audited financial statements shall be filed in the same manner as the Annual Report when they become available.

(2) Financial information relating to the State's General Fund budget for the fiscal year ended on the previous June 30 and information concerning the State budget for the fiscal year in which the Annual Report is issued. Such information shall describe the sources of revenues, the principal categories of expenditures, and changes in fund balances, a summary of expected State revenues and budgeted expenditures, and significant assumptions relating to revenue and expenditure expectations, including updating the following tables which appear under the caption Appendix A—"THE STATE OF CALIFORNIA—Current State Budget" in the Official Statement:

Table Entitled

Summary of State Revenues and Expenditures

Revenue and Expenditure Assumptions

(3) Information concerning the total amount of the State's authorized and outstanding debt, long term lease obligations and other long term liabilities as of the end of the most recent June 30, which debt is supported by payments from the State's General Fund and which includes short-term debt. Such information shall include schedules of debt service for outstanding general obligation bonds and lease-purchase debt. This shall be accomplished by updating the following tables which appear under the caption Appendix A—"THE STATE OF CALIFORNIA—State Indebtedness" in the Official Statement.

Table Entitled

Authorized and Outstanding General Obligation Bonds

Outstanding State Debt

Schedule of Debt Service Requirements for
General Fund General Obligation Bonds

Schedule of Debt Service Requirements for
Enterprise Fund General Obligation Bonds

Schedule of Debt Service Requirements for
Lease-Purchase Debt

State Public Works Board and
Other Lease-Purchase Financing

State Agency Revenue Bonds and
Conduit Financing

The Annual Report may consist of one or more documents. Any or all of the items listed above may be included in the Annual Report by reference to other documents which have been filed by the State with each of the Repositories, including any final official statement (in which case such final official statement must also be available from the Municipal Securities Rulemaking Board). The State Treasurer shall clearly identify in the Annual Report each such document so included by reference.

**Reporting of Significant Events**

The State Treasurer, on behalf of the State shall give, or cause to be given, prompt notice of the occurrence of any of the following events with respect to the Offered Veterans G.O. Bonds (hereafter referred to as a "Listed Event"), if material:

1. principal and interest payment delinquencies;
2. non-payment related defaults;
3. modifications to rights of Bondholders;
4. optional, contingent or unscheduled bond calls;
5. defeasances;
6. rating changes;
7. adverse tax opinions or event affecting the tax-exempt status of the Offered Veterans G.O. Bonds;
8. unscheduled draws on debt service reserves reflecting financial difficulties;
9. unscheduled draws on credit enhancements reflecting financial difficulties;
10. substitution of credit or liquidity providers, or their failure to perform; or
11. release, substitution or sale of property securing repayment of the Offered Veterans G.O. Bonds.

The State Treasurer shall timely file a notice of each such occurrence, if it is material under applicable federal securities laws, with the Municipal Securities Rulemaking Board and each Repository. The State notes that items 8, 9, 10 and 11 above are not applicable to the Offered Veterans G.O. Bonds.

**Other Provisions**

*Termination of Reporting Obligation.* The State's obligations under the Disclosure Certificate shall terminate upon the maturity, legal defeasance, prior redemption or acceleration of all of the outstanding Offered Veterans G.O. Bonds.

*Dissemination Agent.* The State Treasurer may, from time to time, appoint or engage a Dissemination Agent to assist it in carrying out the obligations under the Treasurer's Disclosure Certificate, and may discharge any such Dissemination Agent, with or without appointing a successor Dissemination Agent. If at any time there is not any other designated Dissemination Agent, the State Treasurer shall be the Dissemination Agent. The initial Dissemination Agent shall be the State Treasurer.

*Amendment; Waiver.* Notwithstanding any other provision of the Treasurer's Disclosure Certificate, the State Treasurer may amend or waive any provision of the Treasurer's Disclosure Certificate, provided that the following conditions are satisfied:

(a) If the amendment or waiver relates to the provisions of the Disclosure Certificate dealing with the timing or content of the Annual Report or the giving of notice of Listed Events, it may only be made in connection with a change in circumstances that arises from a change in legal requirements, change in law, or change in the identity, nature or status of an obligated person with respect to the Offered Veterans G.O. Bonds, or the type of business conducted;

(b) The undertaking, as amended or taking into account such waiver, would, in the opinion of nationally recognized bond counsel, have complied with the requirements of the Rule at the time of the original issuance of the Offered Veterans G.O. Bonds, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances; and

(c) The amendment or waiver either (i) is approved by the Holders of 60 percent of the Bonds, or (ii) does not, in the opinion of nationally recognized bond counsel, materially impair the interests of the Holders or Beneficial Owners of the Offered Veterans G.O. Bonds.

*Additional Information.* Nothing in the Treasurer's Disclosure Certificate shall be deemed to prevent the State Treasurer from disseminating any other information, using the means of dissemination set forth in the Treasurer's Disclosure Certificate or any other means of communication, or including any other information in any Annual Report or notice of occurrence of a Listed Event, in addition to that which is required by the Treasurer's Disclosure Certificate. If the State Treasurer chooses to include any information in any Annual Report or notice of occurrence of a Listed Event in addition to that which is specifically required by the Treasurer's Disclosure Certificate, the State Treasurer shall not have any obligation to update such information or include it in any future Annual Report or notice of occurrence of a Listed Event.

*Beneficiaries.* The Treasurer's Disclosure Certificate shall inure solely to the benefit of the Holders and Beneficial Owners from time to time of the Offered Veterans G.O. Bonds, and shall create no rights in any other person or entity (except the right of any Bondholder or Beneficial Owner to enforce the provisions of the Treasurer's Disclosure Certificate on behalf of the Bondholders). The Disclosure Certificate is not intended to create any monetary rights on behalf of any person based upon the Rule.

## *DEPARTMENT'S DISCLOSURE CERTIFICATE*

The Secretary of Veterans Affairs (the "Secretary"), on behalf of the Department, will execute a Continuing Disclosure Certificate (the "Department's Disclosure Certificate") for the Bonds at the time of delivery of the Offered Veterans G.O. Bonds to the purchasers thereof. The following is a summary of the Department's Disclosure Certificate. Such summary is qualified by reference to the complete Department's Disclosure Certificate, which is available from the Department.

### Certain Definitions

Defined terms used in the Department's Disclosure Certificate and not otherwise defined therein have the meanings set forth elsewhere in this Official Statement.

**"Beneficial Owner"** means a Beneficial Owner of Subject Bonds, as determined pursuant to the Rule.

**"Bondowners"** means the registered owners of the Subject Bonds.

**"Bonds"** means, at any time, all of the State's then Outstanding Offered Veterans G.O. Bonds, collectively.

**"Fiscal Year"** means that period established by the Department with respect to which its, as applicable, Audited Financial Statements or Unaudited Financial Statements are prepared. As of the date of the Department's Disclosure Certificate, the Department's Fiscal Year begins on July 1 and ends on June 30 of the next calendar year.

**"MSRB"** means the Municipal Securities Rulemaking Board established pursuant to Section 15B(b)(1) of the Securities Exchange Act of 1934.

**"Notice"** means written notice, sent for overnight delivery via the United States Postal Service or a private delivery service which provides evidence of delivery.

**"Notice Address"** means with respect to the Department:

State of California Department of Veterans Affairs
1227 O Street
Sacramento, CA 95814
Attention: Bond Finance Division

**"NRMSIR"** means, at any time, a then-existing nationally recognized municipal securities information repository, as recognized from time to time by the SEC for the purposes referred to in the Rule.

**"Official Statement"** means this Official Statement.

**"Participating Underwriter"** means any of the original underwriters of any Subject Bonds required to comply with the Rule in connection with the offering of such Subject Bonds.

**"Rule"** means the applicable provisions of Rule 15c2-12 promulgated by the SEC under the Securities Exchange Act of 1934, as amended (17 CFR Part 240, §240.15c2-12), as in effect on the date of the Department's Disclosure Certificate, including any official interpretations thereof.

**"SEC"** means the United States Securities and Exchange Commission.

**"Securities Counsel"** means legal counsel expert in Federal securities laws.

**"SID"** means, at any time, a then-existing state information depository, if any, as operated or designated as such by or on behalf of the State and recognized by the SEC for the purposes referred to in the Rule.*

**"Subject Bonds"** means the Bonds.

**Provision of Annual Financial Information**

The Department will, not later than the first day of the tenth calendar month after the end of each of the Department's Fiscal Years, commencing with the report for the 1997-1998 Fiscal Year, provide to the State Treasurer and to each NRMSIR and the SID the Annual Financial Information. The audited financial statements of the Department may be submitted separately from the balance of the Annual Financial Information, and later than the date required for the filing of the Annual Financial Information if not available by that date.

The Department's Disclosure Certificate requires the Department to provide, in a timely manner, notice of any failure by it to provide Annual Financial Information to each NRMSIR and the SID on or before the date described in the first paragraph under this heading, to the SID, to the State Treasurer, and to either (i) each NRMSIR or (ii) the MSRB.

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*As of the date of this Official Statement, there is no SID.

**Content of Annual Financial Information**

The Department's Annual Financial Information shall contain or include by reference the following:

(a) the audited financial statements of the 1943 Fund for the Fiscal Year ended on the previous June 30, prepared in accordance with generally accepted accounting principles established by the Financial Accounting Standards Board, if available, or unaudited financial statements for such Fiscal Year; and

(b) financial information or operating data of the types included in Exhibit 2 to Appendix B of this Official Statement entitled "Certain Department Financial Information and Operating Data."

If not provided as part of the Annual Financial Information by the date required (as described above under "Provision of Annual Financial Information"), the Department shall provide audited financial statements, when and if available, to the State Treasurer and to each NRMSIR and the SID.

Any or all of the items listed above may be included by specific reference to other documents, including official statements of debt issues of the Department or related public entities, which have been submitted to each NRMSIR and the SID or the SEC. (If such document is an official statement, it must also be available from the MSRB.) Annual Financial Information may be provided in one document or multiple documents, and at one time or in part from time to time.

**Additional Information**

Nothing in the Department's Disclosure Certificate will be deemed to prevent the Department from disseminating any other information, using the means of dissemination set forth in the Department's Disclosure Certificate or any other means of communication, or including any other information in any Annual Financial Information, in addition to that which is required by the Department's Disclosure Certificate. If the Department chooses to include any information in any Annual Financial Information in addition to that which is specifically required by the Department's Disclosure Certificate, the Department will have no obligation under the Department's Disclosure Certificate to update such information or include it in any future Annual Financial Information.

**Amendment of Department's Disclosure Certificate**

The Department's Disclosure Certificate may be amended and any provision of the Department's Disclosure Certificate be waived, without the consent of the Bondowners or Beneficial Owners, except as described in clause 4(ii) below, under the following conditions: (1) such amendment or waiver is made in connection with a change in circumstances that arises from a change in legal (including regulatory) requirements, a change in law (including rules or regulations) or in interpretations thereof, or a change in the identity, nature, or status of the Department or the type of business conducted thereby, (2) the Department's Disclosure Certificate as so amended or waived would have complied with the requirements of the Rule as of the date of each primary offering of Subject Bonds affected by such amendment or waiver, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances, (3) the Department shall have obtained an opinion of Securities Counsel, addressed to the Department and the State Treasurer, to the same effect as set forth in clause (2) above, (4) either (i) a party unaffiliated with the Department (such as bond counsel), acceptable to the Department, has determined that the amendment or waiver does not materially impair the interests of the Beneficial Owners, or (ii) the Bondowners consent to the amendment to or waiver of the Department's Disclosure Certificate, and (5) the Department shall have delivered copies of such amendment or waiver to the SID, to the State Treasurer, and to either each NRMSIR or the MSRB.

In addition to the foregoing, the Department may amend the Department's Disclosure Certificate, and any provision of the Department's Disclosure Certificate may be waived, if the Department shall have received an opinion of Securities Counsel, addressed to the Department and the State Treasurer, to the effect that the adoption and the terms of such amendment or waiver would not, in and of themselves, cause the undertakings in the Department's Disclosure Certificate to violate the Rule, taking into account any subsequent change in or official interpretation of the Rule.

**Benefit; Enforcement**

The provisions of the Department's Disclosure Certificate will inure solely to the benefit of the bondowners and Beneficial Owners from time to time.

*Except* as described in this paragraph, the provisions of the Department's Disclosure Certificate will create no rights in any other person or entity. The obligation of the Department to comply with the provisions of the Department's Disclosure Certificate are enforceable (i) in the case of enforcement of obligations to provide financial statements, financial information, operating data, and notices, by any Beneficial Owner of Outstanding Subject Bonds, or (ii) in the case of challenges to the adequacy of the financial statements, financial information, and operating data so provided, by the Bondowners of not less than 20% in aggregate principal amount of the Subject Bonds at the time Outstanding.

The right to enforce the provisions of the Department's Disclosure Certificate is limited to a right, by action in mandamus or for specific performance, to compel performance of the Department's obligations under the Department's Disclosure Certificate. Any failure by the Department to perform in accordance with the Department's Disclosure Certificate will not constitute a default or an Event of Default under the Subject Bonds, and the rights and remedies provided by the Subject Bonds upon the occurrence of a default or an Event of Default will not apply to any such failure.

**Termination of Reporting Obligation**

The Department's obligations under the Department's Disclosure Certificate with respect to the Subject Bonds terminate upon the legal defeasance, prior redemption, or payment in full of all of the Subject Bonds. The Department shall give notice of any such termination to the SID and to either each NRMSIR or the MSRB.

The Department's Disclosure Certificate, or any provision thereof, will be null and void to the extent set forth on the opinion of Securities Counsel obtained by the Department and addressed to the Department and the State Treasurer, to the effect that those portions of the Rule which require the provisions of the Department's Disclosure Certificate, or any of such provisions, do not or no longer apply to the Subject Bonds, whether because such portions of the Rule are invalid, have been repealed, or otherwise, as will be specified in such opinion, and (2) delivers notice to such effect to the State Treasurer, to the SID and to either each NRMSIR or the MSRB.

**Governing Law**

The Department's Disclosure Certificate will be construed and interpreted in accordance with the laws of the State, and any suits and actions arising out of the Department's Disclosure Certificate will be instituted in a court of competent jurisdiction in the State, *provided that,* to the extent the Department's Disclosure Certificate addresses matters of Federal securities laws, including the Rule, the Department's Disclosure Certificate will be construed in accordance with such federal securities laws and official interpretations thereof.

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# APPENDIX E

## PROPOSED FORMS OF LEGAL OPINIONS

### *PROPOSED FORM OF LEGAL OPINION WITH RESPECT TO THE SERIES BM BONDS*

[closing date]

Office of the Treasurer of the State
of California
Sacramento, California

Ladies and Gentlemen:

We have acted as Attorney General of the State of California and as bond counsel, respectively, and in such capacities we have examined upon request copies of proceedings taken by the State of California (the "State") in connection with the issuance of the State's Veterans General Obligation Bonds, Series BM (collectively, the "Bonds") in the aggregate principal amount of $66,600,000, and the sale of the Bonds to the initial purchasers thereof. The Bonds are issued pursuant to (i) the Veterans Bond Acts identified in Schedule A hereto (collectively, the "Law"), which is incorporated by reference, each of which was approved by the electors of the State, (ii) Part 3 of Division 4 of Title 2 of the California Government Code, and (iii) resolutions (the "Resolutions") adopted by the Veterans Finance Committee of 1943 on February 23, 1998.

The Bonds are dated, mature on the dates in the principal amounts, bear interest, if any, and are payable as provided in the Resolutions. The Bonds are subject to redemption prior to maturity in whole or in part as set forth in the Resolutions.

The State expects to issue its Veterans General Obligation Bonds, Series BN and Series BP on or about May 5, 1998 (the "Series BN and BP Bonds"). The Bonds and the Series BN and BP Bonds are treated as a single issue for certain federal tax purposes under the Internal Revenue Code of 1986, as amended (the "Tax Code"). Applicable federal tax law establishes certain requirements that must be met subsequent to the issuance of the Bonds and the Series BN and BP Bonds in order that interest on the Bonds not be included in gross income for federal income tax purposes under the Tax Code. The Department of Veterans Affairs of the State of California (the "Department") has adopted documents with respect to its program (the "Program Documents") that establish procedures under which, if followed, such requirements can be met. The State and the Department have covenanted in the Resolutions, and in tax certificates and other documents applicable to the issuance of the Bonds (collectively with the Program Documents, the "Documents") to all times perform all acts and things permitted by law and necessary and desirable in order to assure that interest paid on the Bonds shall not be included in gross income for federal income tax purposes under the Tax Code. In rendering this opinion, we have relied upon such covenants and have assumed compliance by the State and the Department with the provisions of such Documents.

In connection with the issuance of the Bonds, we have examined (a) a copy of the Resolutions, and (b) such other opinions, documents, certificates and letters as we deem relevant and necessary in rendering this opinion.

From such examination, we are of the opinion that:

(i) The State has lawful authority for the issuance of the Bonds, and the Bonds constitute the valid and legally binding general obligations of the State payable in accordance with the Law from the General Fund of the State. The full faith and credit of the State of California is pledged for the punctual payment of the principal of and interest on the Bonds.

(ii) Under existing statutes and court decisions, (a) interest on the Bonds is not included in gross income for federal income tax purposes pursuant to Section 103 of the Tax Code, and (b) interest on the Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Tax Code with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. No opinion as to the exclusion from gross income of interest on any of the Bonds is expressed subsequent to any date on which action is taken pursuant to the Documents for which action the Documents require a legal opinion to the effect that taking such action will not adversely affect such exclusion, should the undersigned not deliver an opinion as of such date to such effect.

(iii) Interest on the Bonds is exempt from State personal income taxation under present State law.

In rendering this opinion, we are advising you that the enforceability of the Bonds may be limited by bankruptcy, moratorium, insolvency, or other laws affecting creditors' rights or remedies and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

We have examined an executed Bond and, in our opinion, the form of said Bond and its execution are regular and proper.

Very truly yours,

DANIEL E. LUNGREN,
ATTORNEY GENERAL

[HAWKINS, DELAFIELD & WOOD]

By: ______________________________
Deputy Attorney General

**Schedule A**

1. $6,600,000 principal amount of Veterans Bonds, Series BM1, authorized under the Veterans Bond Act of 1976.
2. $6,600,000 principal amount of Veterans Bonds, Series BM2, authorized under the Veterans Bond Act of 1978.
3. $53,400,000 principal amount of Veterans Bonds, Series BM3, authorized under the Veterans Bond Act of 1996.

***PROPOSED FORM OF LEGAL OPINION WITH RESPECT TO THE SERIES BN AND BP BONDS***

[closing date]

Office of the Treasurer of the State
of California
Sacramento, California

Ladies and Gentlemen:

We have acted as Attorney General of the State of California and as bond counsel, respectively, and in such capacities we have examined upon request copies of proceedings taken by the State of California (the "State") in connection with the issuance of the State's $95,065,000 aggregate principal amount Veterans General Obligation Bonds, Series BN (the "Series BN Bonds") and $10,000,000 aggregate principal amount Veterans General Obligation Bonds, Series BP (the "Series BP Bonds," and, collectively with Series BN Bonds the "Bonds"), and the sale of the Bonds to the initial purchasers thereof. The Bonds are issued pursuant to (i) the Veterans Bond Acts identified in Schedule A hereto (collectively, the "Law"), which is incorporated by reference, each of which was approved by the electors of the State, (ii) Part 3 of Division 4 of Title 2 of the California Government Code, and (iii) resolutions (the "Resolutions") adopted by the Veterans Finance Committee of 1943 on February 23, 1998.

The Bonds are dated, mature on the dates in the principal amounts, bear interest, if any, and are payable as provided in the Resolutions. The Bonds are subject to redemption prior to maturity in whole or in part as set forth in the Resolutions.

The State issued its Veterans General Obligation Bonds, Series BM on or about , 1998 (the "Series BM Bonds"). The Bonds and the Series BM Bonds are treated as a single issue for certain federal tax purposes under the Internal Revenue Code of 1986, as amended (the "Tax Code"). Applicable federal tax law establishes certain requirements that must be met subsequent to the issuance of the Bonds and the Series BM Bonds in order that interest on the Bonds not be included in gross income for federal income tax purposes under the Tax Code. The Department of Veterans Affairs of the State of California (the "Department") has adopted documents with respect to its program (the "Program Documents") that establish procedures under which, if followed, such requirements can be met. The State and the Department have covenanted in the Resolutions, and in tax certificates and other documents applicable to the issuance of the Bonds (collectively with the Program Documents, the "Documents") to all times perform all acts and things permitted by law and necessary and desirable in order to assure that interest paid on the Bonds shall not be included in gross income for federal income tax purposes under the Tax Code. In rendering this opinion, we have relied upon such covenants and have assumed compliance by the State and the Department with the provisions of such Documents.

In connection with the issuance of the Bonds, we have examined (a) a copy of the Resolutions, and (b) such other opinions, documents, certificates and letters as we deem relevant and necessary in rendering this opinion.

From such examination, we are of the opinion that:

(i) The State has lawful authority for the issuance of the Bonds, and the Bonds constitute the valid and legally binding general obligations of the State payable in accordance with the Law from the General Fund of the State. The full faith and credit of the State of California is pledged to the punctual payment of the principal of and interest on the Bonds.

(ii) Under existing statutes and court decisions, (a) interest on the Bonds is not included in gross income for federal income tax purposes pursuant to Section 103 of the Tax Code, and (b) interest on the Series BN Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Tax Code with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations, and (c) interest on the Series BP Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Tax Code with respect to individuals and corporations. No opinion as to the exclusion from gross income of interest on any of the Bonds is expressed subsequent to any date on which action is taken pursuant to the Documents for which action the Documents require a legal opinion to the effect that taking such action will not adversely affect such exclusion, should the undersigned not deliver an opinion as of such date to such effect.

(iii) Interest on the Bonds is exempt from State personal income taxation under present State law.

In rendering this opinion, we are advising you that the enforceability of the Bonds may be limited by bankruptcy, moratorium, insolvency, or other laws affecting creditors' rights or remedies and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

We have examined an executed Bond and, in our opinion, the form of said Bond and its execution are regular and proper.

Very truly yours,

DANIEL E. LUNGREN,
ATTORNEY GENERAL

[HAWKINS, DELAFIELD & WOOD]

By: ______________________________
Deputy Attorney General

**Schedule A**

1. $4,000,000 principal amount of Veterans Bonds, Series BN1, authorized under the Veterans Bond Act of 1980.
2. $4,400,000 principal amount of Veterans Bonds, Series BN2, authorized under the Veterans Bond Act of 1976.
3. $15,400,000 principal amount of Veterans Bonds, Series BN3, authorized under the Veterans Bond Act of 1978.
4. $71,265,000 principal amount of Veterans Bonds, Series BN4, authorized under the Veterans Bond Act of 1996.
5. $10,000,000 principal amount of Veterans Bonds, Series BP, authorized under the Veterans Bond Act of 1990.

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